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Acquisition Finance

Contributing Editors
Johannes Tieves
Hengeler Mueller

Nicholas A. Dorsey
Cravath, Swaine & Moore LLP

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1. MARKET

1.1 Major Lender-Side Players

Guidelines issued by the Reserve Bank of India (RBI) restrict an Indian bank's ability to finance the acquisition of equity shares. Generally, a promoter's contribution towards equity cannot be funded by a bank and banks cannot finance the acquisition of equity shares, other than in exceptional cases. Therefore, financing for a domestic acquisition is generally procured from non-banking financial companies (NBFCs) or by issuance of non-convertible debentures (NCDs) by the acquirer which can be subscribed to by foreign portfolio investors (FPIs), mutual funds and alternate investment funds (AIFs).

NBFCs are registered with the RBI and enjoy a more relaxed regulatory framework compared to banks. International banks often lend through their offices outside India to borrowers based outside India for the purposes of acquisitions in India, or they lend to Indian borrowers for Indian acquisitions through the FPI route (discussed in **1.2 Corporates and LBOs** and **3.1 Senior Loans**).

1.2 Corporates and LBOs

In the Indian context, cross-border acquisitions are commonly classified in two categories.

- Inbound acquisitions, where an offshore acquirer acquires the shares of an Indian target. A slight variation to this structure is the acquisition of an Indian target by a foreign-owned and controlled operating company (FOCC) incorporated in India (which is a subsidiary of an offshore entity).
- Outbound acquisitions, where an Indian acquirer acquires a company incorporated outside India directly or through a special-purpose vehicle incorporated outside India (Offshore SPV).

For an inbound acquisition where the acquisition is through an offshore acquirer, the lending market essentially comprises international banks, capital markets, financial institutions and offshore debt funds. However, such acquisition finance cannot be secured by a pledge on shares of the Indian target, charge on assets of the Indian target or guarantees from the Indian target due to Indian exchange control regulations. Additionally, Indian banks, Indian financial institutions and domestic funds cannot provide finance to an offshore entity to acquire shares of an Indian company.

For an acquisition by an FOCC, finance cannot be provided by Indian banks, Indian financial institutions or domestic funds, as FOCCs are not permitted to leverage in the Indian market for the acquisition of shares. An Indian company can raise foreign currency financing from offshore lenders in the form of external commercial borrowings (ECB), but these cannot be used for equity investments in India. The primary source of debt funding which an FOCC can avail for acquisition of an Indian target is through the issuance of NCDs which can be subscribed to by FPIs. FPIs are registered with the Securities and Exchange Board of India (SEBI) under the SEBI (Foreign Portfolio Investors) Regulations, 2019 (FPI Regulations).

For an outbound acquisition, an Indian acquirer can borrow domestically from banks, financial institutions and other lenders if it complies with certain qualitative and quantitative restrictions. Additionally, if the acquisition of the offshore target is through an Offshore SPV, the Offshore SPV can borrow funds offshore from offshore lenders, funds, capital markets and other financial institutions. Further, ECB can also be raised by an Indian company from overseas lenders and other recognised lenders for acquisition of an overseas target. Creation of security and providing guarantees is also permitted, subject to certain conditions.

Additionally, the Insolvency and Bankruptcy Code, 2016 (IBC) has also opened up a new avenue of acquisition of Indian distressed companies through a statutory process. Such acquisitions domestically, in certain cases, have been leveraged buyouts.

The RBI has also introduced the Prudential Framework for Resolution of Stressed Assets on 7 June 2019, which requires banks to resolve a stressed asset in a time-bound manner and may involve resolution by way of a change of ownership of the borrower. Some leveraged buyouts can be expected in such restructurings.

1.3 COVID-19 Considerations

At the onset of COVID-19 in April 2020, the Government of India issued press note 3 of 2020 (Press Note 3) and the Foreign Exchange Management (Non-debt Instruments) Amendment Rules, 2020 (NDI Amendment Rules) amending certain rules for foreign direct investments from neighbouring countries. These amendments provide that any foreign direct investment:

- from Pakistan, Bangladesh, Afghanistan, Nepal, Bhutan, Myanmar and China (neighbouring countries); or
- where the beneficial owner of any foreign direct investment into India is:
  (a) situated in a neighbouring country; or
  (b) a citizen of a neighbouring country;
- requires approval from the Government of India. Press Note 3 and the NDI Amendment Rules do not prescribe any specific threshold in relation to the term “owner” or “beneficial owner” and, accordingly, no specific threshold is prescribed for investment by an entity (whether direct or indirect) from a neighbouring country.

The Press Note 3 and the NDI Amendment Rules have affected new and proposed foreign direct investments from neighbouring countries and consequently, any financing thereof.

The market has swiftly adjusted to limitations posed by COVID-19 and the lockdowns in India. Some initial hiccups were faced with the electronic signing of documents and making stamp duty payments (which are required to be made before the execution of documents). However, Indian lenders, who are accustomed to physical signings, adapted to using digital signatures or working on the basis of scanned documents (which would be followed up with wet ink signatures). Also, once the lockdown was eased, procuring stamp papers became easier. Certain timelines for registration of documents and obtaining approvals were relaxed due to the COVID-19 pandemic. Lenders (and their counsel) have begun to factor some of these practical issues into the deal timelines and also to plan for these in advance to prevent execution bottlenecks.

2. DOCUMENTATION

2.1 Governing Law

Financing documents for acquisition finance raised by an offshore borrower are typically governed by English law.

Financing documents for acquisition finance raised by an Indian borrower domestically are governed by Indian law. Transaction documents in relation to NCD issuance by an Indian company are also governed by Indian law.

Security and guarantee documents are generally governed by the law of the jurisdiction where the assets are located or the jurisdiction of which the guarantors are nationals or in which they are incorporated.

The choice of foreign law to govern an agreement is generally upheld by Indian courts, unless, in the view of the Indian courts, the choice of foreign law is not bona fide or if the application of foreign law is opposed to the public policy of India. In any proceedings in India, foreign law has to be proved as a matter of fact by leading expert evidence of foreign legal counsel.

2.2 Use of LMAs or Other Standard Loans

In any acquisition financing where the funding is in a foreign currency and obtained from foreign lenders, the credit agreements and intercreditor agreements will generally be based on the latest Asia Pacific Loan Market Association (APLMA) or Loan Market Association (LMA) forms.

For acquisition financings in Indian rupees (INR) where the lenders are Indian NBFCs, funds or FPIs, the nature of documentation varies with every transaction and there is no industry-accepted market standard. Some banks and NBFCs may have their own formats of facility agreements or debenture documents.

In relation to the issue of NCDs, the Companies Act, 2013 (Companies Act), and its related rules, prescribe some prerequisites for the debenture trust deed. The debenture trust deeds are also governed by various SEBI regulations if the NCDs are listed on a stock exchange. In addition, the information memorandum or the offering memorandum for NCDs must be in a format as prescribed by the Companies Act and applicable SEBI regulations.

There is no market-accepted form of documentation for security documents in relation to assets located in India.

2.3 Language

There are no specific legal requirements as to the language in which documentation for acquisition financing is to be drafted. However, all finance documents for acquisition financings, security and guarantee are in the English language.

2.4 Opinions

Where a finance document is executed by an Indian company, resident or national, standard capacity, authority and enforceability legal opinions are issued. The opinions are issued on the basis of the conditions-precedent documents provided by the borrower/obligors.

3. STRUCTURES

3.1 Senior Loans

Inbound Acquisition Finance: Offshore Acquirer

Typically, the offshore acquirer sets up a special-purpose vehicle outside India (FDI SPV) which acquires shares of an Indian target by way of foreign direct investment (FDI) into India. The FDI SPV raises debt from offshore lenders in the form of senior loans to finance the acquisition. Such loans are secured by all the assets and shares of the FDI SPV (other than the shares of the Indian target and any other Indian asset).

Given that there are restrictions under Indian exchange control laws on pledging shares of an Indian target to secure acquisition finance availed by the FDI SPV, generally a non-disposal undertaking is obtained in relation to the Indian target shares held by the acquirer, coupled with a pledge on the acquirer shares.

If the Indian target is a listed company and the FDI SPV holds (together with persons acting in concert) 25% or more shares or voting rights in the target, or controls the target, then any enforcement of the pledge on the shares of the FDI SPV may trigger a mandatory open-offer requirement under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations). A mandatory open offer must be made for at least 26% of the voting shares of the target.

In the case of a sponsor financing, the financing may also benefit from an equity commitment letter from the sponsor.

Inbound Acquisition Finance: FOCC

As mentioned previously, an FOCC cannot avail acquisition finance from Indian banks, financial institutions or Indian funds, as FOCCs are not permitted to leverage in the Indian market for acquisition of shares. If the acquisition is through an FOCC, the debt can be raised by the FOCC by issuance of NCDs which are subscribed to by FPIs. NCDs are structured as senior debt and are secured by all the assets of the FOCC and a pledge on the shares of the target. Further, if the target is a private limited company, security can also be created on the assets of the target to secure the acquisition finance. However, such security may need to be shared with the other lenders of the FOCC and the target.

Outbound Acquisition Finance

For an outbound acquisition made directly by an Indian acquirer, the following financing structures are typically adopted.

- Onshore financing – while the RBI guidelines restrict an Indian bank's ability to finance the acquisition of equity shares of an Indian company, save for exceptional cases, an Indian company can raise loans from Indian banks for an outbound acquisition. Such loans can be utilised by the Indian company towards acquisition of equity in overseas joint ventures/wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment. For financing such an acquisition, an Indian acquirer can also raise funds from NBFCs in India or raise funds by issue of NCDs, which can, inter alia, be subscribed by domestic mutual funds, AIFs and FPIs.
- ECB – ECB can be used by Indian companies for acquisition of shares of an overseas joint venture or wholly owned subsidiary. The guidelines issued by RBI in relation to ECB (ECB Guidelines) stipulate provisions on various matters that need to be considered by a foreign lender when lending to an Indian borrower. Among other things, the ECB Guidelines regulate:
  (a) eligible borrowers – entities that can raise ECB include all entities eligible to receive FDI, port trusts, units in special economic zones, the Small Industries Development Bank of India and the Export–Import Bank of India;
  (b) recognised lenders – ECB can only be extended by the following:
    (i) a lender who is a resident of the Financial Action Task Force (FATF) or an International Organisation of Securities Commission's (IOSCO) compliant country;
    (ii) multilateral and regional financial institutions where India is a member country;
    (iii) individuals who are foreign equity-holders or where the ECB are being raised by the issuance of bonds/NCDs listed outside India; and
    (iv) foreign branches or subsidiaries of Indian banks are permitted as recognised lenders only for foreign currency ECB (except foreign currency convertible bonds and foreign currency exchangeable bonds);
  (c) minimum average maturity – the minimum average maturity period for ECB is three years. No call-or-put options can be exercised during that period; and
  (d) all-in cost ceilings – the maximum all-in cost ceilings allowed for ECB is a six-month London Inter-bank Offered Rate

(LIBOR) (or equivalent benchmark for the other currency) plus 450 basis points. The all-in cost ceilings include rate of interest, other fees, expenses, charges, guarantee fees, export credit agency charges, whether paid in foreign currency or Indian INR, but excludes commitment fees and withholding tax payable in INR.
- Offshore financing – in certain cases, the Indian acquirer sets up an Offshore SPV for acquiring the target in accordance with the guidelines issued by the RBI in relation to overseas direct investments (ODI Guidelines). The Offshore SPV then borrows funds from offshore lenders, funds, capital markets and other financial institutions.

Domestic Acquisition Finance

Domestic acquisition finance is generally structured as NCDs or loans from NBFCs.

The proceeds of NCDs issued on a private placement basis can be used for equity investments. However, the proceeds of unlisted NCDs cannot be used for capital market investments. Further, the proceeds of a public issue of listed NCDs cannot be used for the acquisition of shares of any person who is part of the same group or who is under the same management.

Generally, NCDs are required to have a minimum maturity or duration of one year at the time of investment by the FPI. Any investment by an FPI in NCDs will need to comply with the concentration limits and single or group investor wise limit prescribed by the RBI. It should be noted that:

- investment by any FPI, including investments by related FPIs, shall not exceed 50% of any issue of NCDs;
- in the case that an FPI, including related FPIs, has invested in more than 50% of any single issue, it is not permitted to make further investments in that issue until this requirement is met; and
- FPIs cannot invest in partly paid NCDs.

The RBI has also provided for a separate channel, called the Voluntary Retention Route (VRR), to enable FPIs to invest in NCDs. The investments through the VRR are free of the macro-prudential and other regulatory norms applicable to FPI investments in debt markets, provided FPIs voluntarily commit to retain a required minimum percentage of their investments in India for a specified period. If the FPI is investing in the NCDs under the VRR, minimum average maturity, single-borrower limits and concentration norms do not apply to those NCD investments.

Further, NCDs are required to have a minimum maturity of 90 days. However, if NCDs are issued with a maturity of less than one year, they are regulated by guidelines issued by the RBI in this regard (RBI NCD Guidelines). The RBI NCD Guidelines prescribe stringent guidelines for such issuances, including a minimum rating requirement of "A2" as per rating symbol and definition prescribed by the SEBI and specific eligibility requirement for the issuer.

The NCD route offers greater flexibility on payment of interest to NCD holders, as there are no interest rate caps for privately placed NCDs.

Further, under the ECB Guidelines, eligible borrowers who are participating in the corporate insolvency resolution process (CIRP) under IBC as resolution applicants can raise ECB from all recognised lenders, except foreign branches or subsidiaries of Indian banks, for repayment of rupee term loans of the target company with the prior approval of the RBI.

3.2 Mezzanine/PIK Loans

While payment-in-kind (PIK) loans are not very popular in the Indian scenario, where the borrower is an Indian acquirer, PIK loans are generally structured by way of NCDs. Loans from NBFCs can also be in the form of a PIK loan. Since the RBI requires banks to charge interest on a monthly basis, Indian banks cannot extend PIK loans. However, there have been PIK structures where the borrower is an entity incorporated outside India.

Mezzanine finance is generally raised in the form of compulsorily convertible preference shares, optionally or partially convertible preference shares, compulsorily convertible debentures or optionally or partially convertible debentures. However, if the mezzanine finance is provided by an offshore entity, optionally or partially convertible preference shares or optionally convertible debentures are treated as ECB and will need to comply with the ECB Guidelines.

3.3 Bridge Loans

Bridge loans for acquisition finance are need-based and are raised pending the tie-up of the final financing for the acquisition. These bridge loans for acquisition finance are generally availed from NBFCs. ECB cannot be structured as bridge loans due to their minimum average maturity period requirement. Further, NCDs with a maturity period of less than one year are subject to conditions set out under the RBI NCD Guidelines and are not prevalent.

3.4 Bonds/High-Yield Bonds

ECB can be raised from abroad by issuing bonds. Such bonds can be either listed or unlisted. Given that such bonds are required to comply with the all-in cost ceilings under the ECB Guidelines, such bonds are generally not high yield.

Domestically, bonds are issued as NCDs. Where the issuers are not investment grade, the NCDs can be high-yield bonds as there is no interest cap in relation to the NCDs.

The return on the NCDs can also be linked to the returns on other underlying securities/indices. However, such NCDs must be compliant with the structured product guidelines issued by the SEBI.

3.5 Private Placements/Loan Notes

ECB issued as bonds can be privately placed with the eligible lenders outside India.

An offer or invitation to subscribe to privately placed NCDs can be made to no more than two hundred persons on aggregate in a financial year. Unlisted NCDs need to comply with the Companies Act. Further, if the bonds are listed on a recognised stock exchange in India, their issuance should follow the guidelines issued by the SEBI in this regard, in addition to the Companies Act.

3.6 Asset-Based Financing

As discussed in **5. Security**, security is permitted to be created (to the extent discussed therein) for various financings that may be availed for funding acquisitions. Acquisition finance (as discussed throughout **3. Structures**) can also be asset-backed. The borrower in such structures is usually required to maintain a certain loan-to-value (LTV) ratio or security cover ratio.

4. INTERCREDITOR AGREEMENTS

4.1 Typical Elements

Intercreditor agreements are common in the Indian market where security is shared between multiple lenders. The intercreditor agreements provide for arrangements between various classes of creditors. Generally, the borrower is not a party to the intercreditor agreement. However, it executes an acknowledgement to the intercreditor agreement.

Intercreditor agreements, inter alia, govern the following:

- ranking of security and order of priority amongst the creditors;
- consultation periods before taking any enforcement actions in relation to the security;
- a waterfall for distribution of enforcement proceeds;
- a decision mechanism as to the waiver of events of default;
- voting rights of different classes of lenders;
- collective action and a common approach to security enforcement and exceptions thereto; and
- a mechanism for declaring an event of default and manner of enforcement of security thereafter.

In relation to ECB and acquisition financing, where the acquirer is an Overseas SPV or an FDI SPV and the funding is obtained from foreign lenders, the intercreditor agreements will generally be based on the latest APLMA or LMA forms.

In liquidation of the borrower, an intercreditor agreement between lenders setting out equal ranking, which disrupts the order of priority set out under the IBC, is not required to be considered by the liquidator.

The SEBI has issued a circular which governs the process to be followed by debenture trustees of listed NCDs for enforcement of security and execution of intercreditor agreements.

4.2 Bank/Bond Deals

The approach remains the same as previously set out. If the security is to be shared between the lenders of the borrower and the bondholders, similar intercreditor agreements must be entered into.

4.3 Role of Hedge Counterparties

If the hedges obtained by the borrower are secured with the assets on which other lenders also have security, the hedge counterparties are also parties to the intercreditor agreements. The rights of the hedge counterparty under the intercreditor agreements are synonymous with the ranking of its security.

5. SECURITY

5.1 Types of Security Commonly Used

Security on the assets of an Indian entity and shares of an Indian company is usually created in the following manner:

Immovable Property

Security over immovable property such as land and buildings is created in the form of a mortgage. The Transfer of Property Act, 1882 (TOP Act) primarily governs the creation of mortgages. The common forms of mortgage are an English mortgage (a registered mortgage) and an equitable mortgage (a mortgage created by depositing the title deeds with the lender or security trustee).

The TOP Act provides that a mortgage (other than an equitable mortgage) for repayment of money exceeding INR100 must be created by way of a registered instrument. The instrument creating the mortgage is required to be signed by the mortgagor and registered with the land registry where the mortgaged immovable property is situated.

For an equitable mortgage, the authorised representative of the mortgagor deposits the title deeds in relation to the immovable property with the lender or security trustee with an intention to create a mortgage, and provides a declaration at the time of the deposit. The lender or security trustee records the deposit of title deeds by way of a memorandum of entry. In some states, an equitable mortgage needs to be registered or notified to the land registry.

Shares and other Securities

Security over shares and other securities is typically created by way of a pledge. A pledge agreement or deed is entered into between the pledgor and the pledgee to create and record the pledge. A separate power of attorney is also issued by the pledgor in favour of the pledgee that allows the pledgee to deal with the pledged shares/securities in the case of an event of default and take other actions on behalf of the pledgor.

Movable Property

Movable property, such as receivables, plant and machinery, accounts and stock, is usually secured by way of hypothecation. Under Indian law, hypothecation generally means a charge over any movable property. The charge created by way of hypothecation may be a fixed charge over identifiable assets or fixed assets and is usually a floating charge over current assets and stock-in-trade.

The security-provider executes a deed of hypothecation in favour of the lender or security trustee.

India is an exchange-controlled economy and creation of security on the assets of an Indian company in favour of persons outside India or assets of a non-resident Indian in India is governed by the Foreign Exchange Management Act, 1999 (FEMA) and rules and regulations are framed thereunder. Any cross-border security or guarantee is governed by the FEMA. The security that can be created for the various acquisition finance structures is discussed below.

Inbound Acquisition Finance: Offshore Acquirer

Any acquisition financing availed by an offshore acquirer for the purpose of acquiring the shares of an Indian company cannot be secured by a pledge on the shares acquired by the offshore acquirer without the prior approval of the RBI.

Further, no security can be created on the Indian assets of the target or any other person resident in India for securing any such acquisition finance.

Inbound Acquisition Finance: FOCC

As the acquisition finance availed by an FOCC by way of NCDs is domestic debt, this debt can be secured by Indian assets of the FOCC. Security on Indian assets of the target will be subject to financial assistance rules. However, prior approval of the RBI is required for creation of pledge on the shares of the FOCC held by the non-resident shareholder to secure the NCDs.

Outbound Acquisition Finance

The following security can be created in the case of an outbound acquisition finance, subject to the Indian entity complying with the conditions and other qualitative and quantitative restrictions set out under Overseas Direct Investment (ODI) Guidelines after obtaining the approval of the authorised dealer bank (ie, banks in India that have been given special licences to deal with foreign exchange):

- a pledge on the shares of overseas target or the Offshore SPV held by the Indian acquirer to secure loans availed from an authorised dealer bank in India or a public financial institution in India;
- a pledge on the shares of the Offshore SPV held by the Indian acquirer to secure a facility availed by it from overseas lenders that are regulated and supervised as banks, if the facility is utilised only for core business activi-

ties of the Offshore SPV outside India and not for investing back in India;
- a charge on the assets of the Indian shareholder of the Offshore SPV, its group company, sister concern or associate company in India, promoters and/or directors to secure a facility availed by it from overseas lenders that are regulated and supervised as banks, if the facility is utilised only for core business activities of the Offshore SPV outside India and not for investing back in India; and
- a security on the assets of the Offshore SPV or the overseas target to secure loans availed from an authorised dealer bank in India.

The value of the facility is assessed as a financial commitment for the Indian party and the total financial commitment of the Indian party should be within the limits set out in the ODI Guidelines. Currently, this limit is 400% of the net worth of the Indian acquirer, which should not exceed USD1 billion in one financial year.

In the case of ECB, the RBI has permitted authorised dealers to grant permission in relation to the creation of security over movable property, immovable property and financial securities in favour of or for the benefit of an ECB lender.

Domestic Acquisition Finance

Acquisition finance by an Indian entity by way of NCDs or loans from NBFCs is domestic debt and this debt can be secured by Indian assets of the acquirer and the Indian group companies of the acquirer.

The acquisition finance availed by an Indian acquirer from Indian banks or financial institutions for an outbound acquisition can be secured by security on the Indian assets of the acquirer or the Indian group companies of the acquirer.

5.2 Form Requirements

Generally, the following perfection requirements exist in relation to the security created on the assets of an Indian company:

- any security on movable or immovable assets of a company or pledge on shares held by an Indian company is required to be registered with the registrar of companies (ROC) within 30 days of the creation of the charge;
- any security by way of mortgage or hypothecation is required to be registered with the Central Registry of Securitisation Asset Reconstruction and Security Interest of India;
- mortgages (except equitable mortgages) of immovable property have to be registered as per the Indian Registration Act, 1908 within four months of the execution of the mortgage deed with the concerned land registry. Further, in certain states, equitable mortgages are also required to be registered or notified with the land registry concerned; and
- for shares and other securities held in dematerialised form, forms are required to be filed with the depository participant to create a pledge or a non-disposal undertaking.

5.3 Registration Process

See **5.2 Form Requirements** for various security perfection and registration requirements. Further, any security created under the ODI Guidelines will also need to be reported to the RBI through the authorised dealer bank in the form prescribed under the ODI Guidelines.

5.4 Restrictions on Upstream Security

Generally, upstream security can be provided by an Indian company for the indebtedness of its Indian holding company, subject to compliance with the provisions of the Companies Act. See the discussion in **5.6 Other Restrictions** in relation to shareholder resolutions and common directors that will need to be complied with for creation of any such security. The creation of upstream security by an Indian company for financing availed by an offshore holding company is restricted under the FEMA.

However, upstream security on the assets of the target (which is not a private company) may not be possible for a debt used to acquire the shares of the target. See the discussion in **5.5 Financial Assistance**.

5.5 Financial Assistance

As per the Companies Act, a public company (whether listed or not) is prohibited from providing any direct or indirect financial assistance to any person for subscription to, or for the purchase of, its own shares or the shares of its holding company. The term "financial assistance" is broad and includes assistance in the form of loans, guarantees and the provision of security. This restriction does not apply to a private company.

In view of the foregoing, a target company that is a public company cannot create security or provide guarantees in relation to acquisition finance availed for acquisition of its shares.

5.6 Other Restrictions

Shareholders' approval by way of special resolution (75%) is required under the Companies Act for an Indian company to provide any guarantee or security if certain prescribed thresholds (in terms of paid-up capital and free reserves) are exceeded. However, this approval is not required if the guarantee or security is being provided for a financing utilised by the company's wholly owned subsidiary or joint venture.

As per the Companies Act, a company (lending company) cannot give loans, provide security or extend any guarantee to or on behalf of any other company in which the directors of the lending company are interested or control a certain percentage of voting rights unless such a loan, guarantee or security falls within the exemptions prescribed under the Companies Act. Certain relevant exceptions to this rule are:

- loans made by a holding company to its wholly owned subsidiary company or any guarantee given, or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company, if the loans are utilised by the wholly owned subsidiary for its principal business activities;
- a guarantee given or security provided by a holding company in respect of loans made by any bank or financial institution to its subsidiary company, if the loans are utilised by the wholly owned subsidiary for its principal business activities:
- if the lending company, in the ordinary course of its business, provides loans or guarantees or security for the due repayment of any loan and in respect of those loans, an interest is charged at a rate not less than as specified under the Companies Act; or
- if the lending company obtains the approval of at least 75% of its shareholders for any guarantee given or security provided, and the loans availed by the borrower are utilised by it for its principal business activities.

5.7 General Principles of Enforcement

Generally, a lender may enforce its security on the occurrence of an event of default. The process to be followed for enforcement of the security is briefly set out below.

Immovable Property

If the mortgage is an English mortgage, the mortgagee has the power to sell the mortgaged property without the intervention of the court, subject to certain notification requirements. Where the mortgage is an equitable mortgage, the mortgagor must apply to the court for a decree to sell the mortgaged property in order to recover the debt.

Indian banks, certain notified financial institutions and debenture trustees for listed and secured NCDs can enforce a mortgage under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI), which provides for a quicker mode of enforcement of security.

Movable Property

The rights and remedies of a hypothecatee are entirely regulated by the terms of the deed of hypothecation between the hypothecator (security-provider) and hypothecatee (the lender). A deed of hypothecation can be enforced either by appointing a receiver and selling the charged assets or by obtaining a decree for sale of the movable property. Indian banks, certain notified financial institutions and debenture trustees for listed and secured NCDs can enforce hypothecation under the SARFAESI, which provides for a quicker mode of enforcement of security.

Pledge over Shares

A pledgee may enforce a pledge by giving reasonable notice of enforcement to the pledgor. The pledgee does not need to obtain a court order to sell the pledged shares. If the pledged shares are held in physical form, the pledgee must submit to the company whose shares are pledged the executed share transfer forms held by the pledgee. The company will then need to approve the transfer of shares in the name of the lender or third-party transferee at its board meeting. If the company refuses to approve the transfer of shares, the lender or third-party transferee will need to approach the competent courts and tribunals to challenge that refusal.

If a company is admitted to the Corporate Insolvency Resolution Procedure (CIRP) under the IBC or a pre-packaged insolvency resolution process commences against a company under the IBC, no security can be enforced, due to the moratorium imposed under the IBC. Where the company is to be liquidated under the IBC, a secured creditor will have an option to realise its security and receive proceeds from the sale of the secured assets as first priority. Additionally, in the case of any shortfall in recovery, the secured creditors will rank junior to the unsecured creditors to the extent of the shortfall.

6. GUARANTEES

6.1 Types of Guarantees

Generally, a guarantee is obtained from the holding or group company of the acquirer or the target (where financial assistance rules are not attracted).

If the guarantee is issued by a non-resident entity for an NCD, that guarantee will need to comply with the following key conditions:

- any such guarantees can be issued by eligible non-resident entities (such as multi-lateral financial institutions, regional financial institutions and Government-owned (either wholly or partially) financial institutions and direct or indirect equity-holders);
- the borrower should be eligible to raise ECB under the automatic route;
- the NCD should have a minimum average maturity of three years and no call-or-put options are permitted during that period; and
- guarantee fees and other costs in respect of the guarantee cannot exceed 2% of the principal amount involved.

Indian entities cannot provide guarantees for the obligations of their overseas parent company.

An ECB can be guaranteed upon obtaining a no-objection from an authorised dealer, as per the ECB Guidelines. If the guarantee is issued by a non-resident entity, the guarantor is required to fulfil the qualification of a recognised lender under the ECB Guidelines.

Under the ODI Guidelines, an Indian company which holds shares in an Offshore SPV (Indian Party), can provide a guarantee or procure a guarantee from indirect resident individual promoters of that Indian Party, the promoter company, group company, sister concern or associate company of the Indian Party, subject to certain qualitative and quantitative requirements specified in the ODI Guidelines, including the following:

- the guarantee should not be open-ended. The amount and the validity period of the guarantee should be specified upfront;
- all the financial commitments, including all forms of loans, guarantees, investments and creation of charge must be within the overall ceiling prescribed for the Indian Party under the ODI Guidelines (currently, 400% of the "net worth" of the Indian Party as per the last audited balance sheet of the Indian Party and which should also not exceed USD1 billion (or its equivalent) during a financial year);
- the Indian Party should not be on the RBI's Exporters' caution list, a list of defaulters to the banking system circulated by the RBI or the TransUnion CIBIL Limited, or any other credit information company as approved by the RBI or under investigation by any investigation or enforcement agency or regulatory body.

See also **5.6 Other Restrictions** in relation to the restrictions under the Companies Act for issuance of guarantees.

6.2 Restrictions

See **5.6 Other Restrictions** in relation to the restrictions under the Companies Act for issuance of guarantees.

6.3 Requirement for Guarantee Fees

It is not mandatory under Indian law for the borrower to pay a guarantee fee to the guarantor. Prior approval of the RBI may be required for payment of any guarantee fees by a person in India to a person outside India in relation to a guarantee issued by that person for an INR loan.

7. LENDER LIABILITY

7.1 Equitable Subordination Rules

The IBC provides for a payment waterfall for the creditors in the event of the liquidation of a company. The priority waterfall for distribution of liquidation proceeds, prescribed under the IBC, is as follows:

- the costs of the insolvency resolution (including any interim finance);
- secured creditors (who are not enforcing their security outside the liquidation), together with workmen's dues for the preceding 24 months;
- any unpaid dues owed to employees other than workmen and wages for the period of 12 months preceding the liquidation commencement date;
- financial debts owed to unsecured creditors;
- amounts payable to the Central and State Governments for the preceding 24 months, and unrealised dues of secured creditors outside the liquidation;
- any remaining debts and dues;
- preference shareholders, if any; and
- equity shareholders or partners, as the case may be.

The National Company Law Tribunal (NCLT), in one of the cases under the CIRP, has also held that the unsecured intra-group debt from a related party should be treated as an equity contribution rather than an intra-group loan. These intra-group loans should rank lower in priority than the same obligations between unrelated parties.

Further, in one of the judgments, the National Company Law Appellate Tribunal has also held that promoters or shareholders cannot claim to have been discriminated against if no amount is given to the promoters or shareholders while the other equity shareholders of a corporate debtor who are not the promoters have been separately treated and have been provided certain amounts under the resolution plan.

7.2 Claw-Back Risk

The different preference periods or reasons for claw-back during insolvency or the CIRP of an Indian company are set out as follows.

Preferential Transaction

Under the IBC, a corporate debtor shall be deemed to have been given preference if:

- there is a transfer of property or an interest therein of the corporate debtor for the benefit of a creditor or a surety or a guarantor for or other liabilities owed by the corporate debtor; and
- that transfer has the effect of putting the creditor or a surety or a guarantor in a more beneficial position than it would have been in the event of distribution of assets being made in liquidation of the corporate debtor.

However, the following are not considered as preferential transactions:

- transfer in the ordinary course of business or financial affairs of the corporate debtor and the transferee;
- any transfer creating a security interest in property acquired by the corporate debtor, if:
  - (a) that security interest secures new value and was given at the time of, or after the signing of, a security agreement that contains a description of the property as security interest and was used by the corporate debtor to acquire that property; and
  - (b) the transfer was registered with an information utility on or before 30 days after the corporate debtor received possession of the property.

The claw-back period in relation to a related party (other than being an employee) is two years preceding the insolvency commencement date (ICD) and for a non-related party is one year preceding the ICD.

Undervalued Transaction

A transaction (other than a transaction in the ordinary course of business of the corporate debtor) is considered undervalued where the corporate debtor makes a gift to a person or enters into a transaction with a person that involves the transfer of one or more assets by the corporate debtor for a consideration, the value of which is significantly less than the value of the consideration provided by the corporate debtor.

However, the following transactions are not considered undervalued:

- any interest in property that was acquired from a person other than the debtor and was acquired in good faith, for value and without notice of the relevant circumstances; and
- a person received a benefit from the transaction in good faith, for value and without notice of the relevant circumstances, unless he or she was a party to the transaction.

The claw-back period in relation to a related party is two years preceding the ICD and for a non-related party one year preceding the ICD.

Undervalued Transaction Defrauding Creditors

An undervalued transaction (as previously discussed) entered into by a corporate debtor is considered to be entered into for defrauding the creditor if the NCLT is satisfied that the transaction was deliberately entered into by that corporate debtor for keeping the assets of the corporate debtor away from any person entitled to make a claim against the corporate debtor; or to affect adversely the interest of that person in relation to the claim.

No specific claw-back period is specified for such transactions.

Extortionate Credit Transaction

Extortionate credit transactions are transactions where the corporate debtor is a party to a transaction involving the receipt of financial or operational debt during the period within two years preceding the ICD and where the terms of the transaction:

- require the corporate debtor to make exorbitant payments in respect of the credit provided; or
- are unconscionable under the principles of law relating to contracts.

However, any debt extended by any person providing financial services which is in compliance with the law is not considered as an extortionate credit transaction.

8. TAX ISSUES

8.1 Stamp Taxes

Stamp duty is required to be paid on a facility agreement and security documents at or prior to execution. An insufficiently stamped document is not admissible as evidence in a court of law. Stamp duty differs from state to state and is determined based on the nature of the document.

8.2 Withholding Tax/Qualifying Lender Concepts

Currently, the applicable rate of withholding tax on interest payable by an Indian company to a non-resident lender (situated outside India) on ECB and Rupee Denominated Bonds is 5% (plus applicable surcharge and cess), subject to the satisfaction of certain conditions and provision of prescribed documents. This tax is withheld from the interest payable to the lender and deposited on the lender's behalf with the government. The tax withholding rate of 5% is not applicable if the lender is the branch of a foreign bank located in India.

Foreign banks which have a branch in India have the option of applying for and obtaining a certificate allowing the borrower to deduct tax at a lower appropriate rate, having regard to the overall tax liability of the Indian branch of the foreign bank. Upon the sharing of such a certificate with the borrower, it can withhold tax at the rate prescribed therein.

The act of withholding the tax is an obligation of the borrower, who is also required to issue a certificate evidencing this. The lender can take the credit of the tax withheld on interest to meet its tax liabilities in India as well as in the country of residence.

8.3 Thin-Capitalisation Rules

Interest paid on debt incurred to acquire equity or preference shares (held as capital asset and not as stock-in-trade) is not considered deductible for tax purposes.

Provisions dealing with thin capitalisation in respect of other interest payments are embodied in the Indian Income Tax Act 1961 (IT Act). These impose limitations on the deduction of excess interest (ie, any amount that exceeds 30% of the earnings before interest, taxes, depreciation and amortisation (EBITDA) of the Indian company or permanent establishment (PE)) incurred by way of interest or payments of a similar nature by an Indian company or a permanent establishment (PE) of a foreign company to its non-resident associated enterprise in respect of debt borrowed.

The thin-capitalisation rules are also applicable in instances of interest payments to third-party lenders who provide a loan on the basis of an associated enterprise, either providing an explicit or implicit guarantee to that third-party lender or depositing a corresponding amount with that lender.

Thin-capitalisation provisions are not applicable to Indian companies and PEs of the non-residents engaged in the banking or insurance business.

The above rules are applicable only where the interest or payments of a similar nature exceed INR10 million. The interest expense that is disallowed against income shall be allowed to be carried forward and allowed as a deduction against profits and gains of any business or profession carried out for up to eight assessment years, subject to the limits mentioned.

9. TAKEOVER FINANCE

9.1 Regulated Targets

Other than in relation to the acquisition of a listed target (as discussed in **9.2 Listed Targets**), there are no specific regulatory requirements to demonstrate certain funds.

Indian sellers may, in certain cases, expect bidders to demonstrate that they have binding commitments before selecting a winning bidder and executing definitive documentation.

Under the IBC, a resolution applicant (bidder for the company under a CIRP) is required to submit performance security after approval of its bid. The performance security will be forfeited if the resolution applicant fails to implement the resolution plan.

9.2 Listed Targets

If an acquisition of a listed company triggers the requirement of making an open offer by the acquirer under the Takeover Regulations, the acquirer is required to fund an escrow account with the required funds in accordance with these regulations. The funds can be provided in the form of cash deposited in an escrow account, a bank guarantee issued in favour of the manager to the offer by any scheduled commercial bank or the deposit of frequently traded and freely transferable securities with an appropriate margin. Where the acquirer proposes to fund the escrow account by availing financing, the manager to the offer may need to be satisfied that the financing is available.

10. JURISDICTION-SPECIFIC FEATURES

10.1 Other Acquisition Finance Issues

Disclosure of an Encumbrance on Listed Shares

Under the Takeover Regulations, shares taken by way of an encumbrance are treated as acquisitions and are required to be disclosed. Similarly, shares released from an encumbrance are treated as sale and are also required to be disclosed.

The Takeover Regulations have been amended and define “encumbrance” widely to include (i) any restriction on the free and marketable title to shares, by whatever name called, whether executed directly or indirectly; (ii) pledge, lien, negative lien, non-disposal undertaking; or (iii) any covenant, transaction, condition or arrangement in the nature of encumbrance, by whatever name called, whether executed directly or indirectly.

The SEBI, in its frequently asked questions on the Takeover Regulations, has clarified that any arrangement which risks the shares of the listed company being appropriated ought to be disclosed as being an encumbrance. Disclosure requirements apply to: (i) any acquisition of shares or voting rights in excess of 5% and thereafter any change in shares or voting rights so disclosed where that change is in excess of 2% when compared to the last disclosure; and (ii) any encumbrance created by the promoter on the shares of the listed entity.

Therefore, covenants or other conditions in the financing documents which have the effect of creating an encumbrance on the shares or voting rights of the listed company may require disclosures under the Takeover Regulations. Any such covenants may include any borrowing limits linked to the value of listed shares, a requirement to hold a specific number or value of the listed shares and a consent requirement for disposal of the listed shares.

Issuance of Listed NCDs

As a matter of recent practice, stock exchanges have sought audited financial statements for three years for any entity that proposes to issue NCDs which will be listed. This may impact deal structures which contemplate that a newly formed SPV will raise acquisition finance (specially where that SPV is an FOCC) by way of NCDs.

Contributed by: Aashit Shah, Utsav Johri, Nakul Sonejee and Prakrati Shah, **J. Sagar Associates**

J. Sagar Associates is a leading national law firm in India. The firm has over 320 attorneys operating out of seven offices: Ahmedabad, Bengaluru, Chennai, Gurgaon, Hyderabad, Mumbai and New Delhi. For over 25 years, the firm has provided legal representation, advice and services to leading international and domestic businesses, banks, financial services providers, funds, governmental and statutory authorities, and multilateral and bilateral institutions. JSA has a distinguished and market-leading banking and finance practice in India. The firm has been involved in several complex and bespoke cross-border and domestic acquisition finance and leveraged finance assignments for banks, financial institutions, funds, sponsors and corporates, in a variety of different formats, including loans, non-convertible debentures and external commercial borrowings. With a team of over 35 attorneys in the banking and financing practice, JSA possesses the expertise and resources to provide comprehensive, commercially oriented and practical advice and solutions to its clients.

AUTHORS

Aashit Shah is a partner and chair of the finance practice at JSA. He has been practising law since 2001, and specialises in acquisition and leveraged finance, domestic and cross-border lending, real estate finance, M&A, private equity, restructuring and insolvency. He is admitted to the Bar Council of Maharashtra and Goa and is a member of the International Bar Association and INSOL International. He has contributed to numerous publications in the field of acquisition finance.

Utsav Johri is a partner in the finance practice at JSA. He has advised Indian and multinational banks, financial institutions and Indian borrowers extensively on diverse complex financing structures. His practice areas include acquisition and leveraged finance, cross-border finance, priority funding and debt capital markets. He has also been actively involved in various debt restructuring and security enforcement assignments. He is admitted to the Bar Council of Maharashtra and Goa and has been practising law since 2008. He has contributed to several publications in the area of acquisition finance.

Nakul Sonejee is a senior associate in the finance practice at JSA. His primary areas of focus are domestic and cross-border financing transactions. He regularly advises Indian and multinational banks and financial institutions in relation to corporate finance, acquisition finance and structured finance. In addition, he regularly advises domestic and international banks on all types of general banking products. Nakul has been practising law since 2016.

Prakrati Shah is an associate in the banking and finance practice of the firm. She focuses primarily on domestic and cross-border finance transactions, including by way of external commercial borrowings and the issuance of privately placed non-convertible debentures.

J. Sagar Associates

Vakils House
18 Sprott Road
Ballard Estate
Mumbai 400 001
India

Tel: +91 22 4341 8600
Fax: +91 22 4341 8617
Email: aashit@jsalaw.com
Web: www.jsalaw.com

jsa
advocates & solicitors