Managing Foreign Buyers' Risks in Indian M&A Transactions

Foreign buyers looking to acquire or invest in Indian companies are challenged with known and unknown risks similar to other jurisdictions. However, certain aspects of India's exchange control rules, occasions of retrospective changes in law, cultural unfamiliarity and market practices unique or common to India often surprise foreign buyers and impose additional risks that have to be navigated by foreign buyers in Indian M&A transactions. Dealing with such risks appropriately requires not just an assessment and classification of risks but also development of required strategies for risk management within the Indian legal framework. This note discusses certain common risks for foreign buyers in Indian M&A transactions and strategies to mitigate such risks.

KNOWN RISKS

Known risks involve issues that are known through publicly available information, discovered during diligence or disclosed by sellers in a disclosure schedule in response to representations and warranties. To the extent risks are quantifiable and ascertainable, such as any admitted claims, pending penalties, costs of non-compliance, etc., buyers should consider reducing the valuation of the target company upfront during their discussion with sellers. It is also common practice for buyers and sellers to discuss and consider resolution of known risks either prior to signing binding transaction documents or by including them as conditions precedent or conditions subsequent (depending upon the timing for resolution and materiality of the risk involved) to closing in the transaction documents. Other mitigation strategies for known risks could include one or all of the following:

Limiting the information included in the disclosure schedule

Sellers typically provide disclosures on a "*except as disclosed*" basis as an exception to the representations and warranties clause. It is common practice for buyers to insist

that the disclosure schedule and the disclosures therein should be in a form acceptable to the buyer. It is beneficial for the buyer to review the disclosure schedule before it is finalized and consider which disclosures can be accepted and whether material disclosures have been protected by adequate remedial measures in the transaction documents. If an appropriate remedy cannot be agreed upfront, certain buyers insist that the sellers remove the disclosure, and any loss arising from such risk may then be covered by a general indemnity. Buyers should include language in the transaction documents to ensure that no limitation on general indemnity or warranties by the sellers are modified, limited or qualified by buyers' knowledge of risks, whether disclosed or not.

Purchase price holdback

Holdback covenants may be included in payment clauses of transaction documents wherein a portion of the purchase price is held back until a specified time in anticipation of risks that cannot be quantified, adjusted or resolved with certainty prior to closing of the transaction. Holdback of purchase price may be included for both known and unknown risks and in the event any risk materializes post-closing, the amount of loss suffered, or indemnity claim in this regard may be set off against the holdback amount.

The exchange control rules in India, permit up to 25% of the consideration amount to be paid by the foreign (non-resident) buyer on a deferred basis to a (resident) Indian seller within a maximum period of 18 months from the date of the share purchase agreement without prior approval of the Reserve Bank of India (the "**RBI**"). A longer holdback period will require the prior approval of the RBI. Such restrictions will not apply for a transaction between a foreign buyer and a foreign seller. A deferred consideration arrangement could also be structured through an escrow mechanism.

Specific indemnity

Specific indemnity items list down certain known risks and provide protection to the buyer from such identified risks. This is commonly included in transaction documents in Indian M&A transactions and can provide comfort to buyers to close transactions even when sellers have not agreed to an upfront purchase price valuation adjustment. Typically, such specific indemnity items are also not subject to limitations (including time and amount caps) and the buyer is entitled to recover the entire amount of loss from the seller.

UNKNOWN RISKS

The doctrine of *caveat emptor* as interpreted by courts in India in the context of Indian M&A transactions lays down that the buyer has the responsibility to conduct diligence

and be aware of the risks involved. This doctrine is qualified by reasonable diligence on the part of the buyer. The diligence process undertaken by a buyer should ideally identify all material risks in the target company and the transaction. However, this process is typically limited to information disclosed by the seller and publicly available information. M&A transactions in India like other jurisdictions cannot rule out the possibility of seller fraud, misrepresentations, breach of material covenants such as non-compete, willful misconduct and deceit in relation to the target company, its shares or assets and liabilities. There have been many such reported and alleged incidents in India where buyers or investors have been drawn into prolonged legal battles for issues such as fraudulent accounting statements, mismanagement or siphoning of company funds and pre-closing non-compliance with laws and regulations, including non-payment of taxes. Buyers typically obtain protection against such unknown risks through the following:

Representations and warranties, materiality scrapes and indemnity

Sellers provide extensive representations and warranties regarding the target company, its shares and assets and liabilities being transferred. These clauses form the foundation of the understanding between the buyer and seller and are often heavily negotiated. These clauses provide confirmation in relation to certain matters, breach of which would give rise to indemnification or termination, as negotiated.

Buyers commonly rely on obtaining a general indemnity against misrepresentations and inaccuracy in representations and warranties. However, it is common for sellers to limit the buyers' indemnity protection with materiality thresholds, survival limits and caps.

Materiality thresholds are a form of qualifiers negotiated into transaction documents by sellers in their representations and warranties. Materiality thresholds are usually subjective to the risk tolerance of buyers, nature of industry and size of the transaction. Sellers demarcate these thresholds to ensure that they are not liable for breaches and damages which are not material. Materiality scrapes are strategies which buyers must use to protect themselves against materiality thresholds. This is done by adding in adequate language disregarding materiality thresholds for the purposes of determining a breach of the representation or warranty and for the quantum of losses or damages that may occur. While it is unlikely for sellers to agree to blanket removal of all materiality thresholds, buyers should push back on the limits of deductible and basket which also functions as a threshold for claims as this would result in a double materiality threshold in favor of sellers.

While two to three audit cycles after closing may generally be sufficient for buyers to access likelihood of any unknown risks, certain risks such as related to tax where Indian laws provide a longer statutory period for tax authorities to make a claim, the entire statutory period should be the survival period in relation to recovery of a tax claim. It is also common in Indian M&A transactions for certain fundamental warranties including warranties related to title, authority and capacity and anti-bribery to survive in perpetuity.

Buyers also include language in transaction documents permitting a set-off of any indemnity claim with any deferred consideration or holdback amount or any other contractual payment or claim of the sellers against the buyer. However, foreign buyers must note that the exchange control rules in India permit the resident seller to provide an indemnity for up to 25% of the total consideration for a period of up to 18 months from the date of payment of the full purchase consideration. Indemnity payments beyond such 18-month period and 25% limit will require prior RBI approval.

Protection against fraud, willful misconduct and gross negligence

Foreign buyers can also face unknown risks arising on account of acts of fraud, misconduct or negligence on the part of sellers. It is common for buyers to seek blanket protection without any limitations as to survival period or indemnity caps or disclosure exceptions from the sellers. While establishing fraud (under Indian criminal or civil law) and willful misconduct under Indian criminal law necessarily requires *mens rea* and a high burden of proof, the standard for gross negligence considered by Indian courts is of recklessness. Considering the high burden of proof to establish such acts, we are increasingly seeing buyers trying to negotiate an appropriate definition of fraud, willful misconduct and gross negligence that may extend the scope to certain defined acts and even attempt to shift the presumption and burden of proof onto sellers.

Protection against retrospective amendments

Unforeseeable risks are of nature that cannot be reasonably predicted. India has a notorious history of retrospective amendments to tax laws which have previously resulted in massive taxes including interest and penalties being levied on foreign buyers. These have resulted in long drawn court battles and international treaty arbitrations before any relief was received by such foreign buyers. While the current Indian government has been more careful in making any retrospective amendments that adversely impact foreign buyers, it has become common in M&A negotiations for the buyer and seller to discuss and allocate any risk that may arise on account of any new retrospective amendment to law.

In the recent past, investors have been subject to expensive dispute resolution processes in relation to challenges against retrospective tax amendments in India, under applicable bilateral investment treaties. Foreign buyers have therefore been pushing for clarity in risk allocation and continuing to seek protection from retrospective amendments in Indian law, within the transaction documents.

Representation and warranty ("R&W") insurance

R&W insurance helps the buyer transfer the risk of a breach of representations and warranties to a creditworthy insurer. From the perspective of a foreign buyer, relying on R&W insurance rather than an individual seller or a group of sellers to recover indemnity claims may be a more desirable position given the challenges involved in enforcing indemnity claims against resident Indian sellers and liquidity of funds with such sellers. However, while sellers see merit in R&W insurance, often the success in obtaining R&W insurance from the buyers' perspective would depend upon sellers agreeing to pay the cost of insurance. Additionally, buyers should obtain adequate protection against limitations of the insurance policy and carve outs which are not covered by R&W insurance within the transaction documents.

Non-compete

Sellers who have had prior experience in running the target company have an in-depth idea about the business, the market and competitors and therefore pose a serious threat in starting a competing business in the same market. It is common to include non-compete clauses in M&A transaction documents to mitigate this risk, by imposing a restriction on the sellers to not start a competing business pursuant to the transaction. However, it is vital to draft the clause such that it does not violate Section 27 of the Indian Contract Act, 1872 ("**Section 27**") which voids agreements in restraint of trade. Section 27 also provides an exception such that a person selling a business (along with the associated goodwill) may agree with the buyer to refrain from carrying on similar business, within specified local limits, for a period that the buyer (or any person deriving title to the goodwill from him) carries on a similar business. Buyers should also ensure that the clause is tightly drafted to prevent misuse to the extent possible by the seller using affiliates, related parties or in some instances unrelated parties that derive either funding, know-how or other commercial advantage by association or patronage from the sellers.

Buyers should also be cognizant of potential competition law issues by ensuring that the non-compete clause reasonably demarcates the geographical area, subject matter, scope of prohibited activities and period of time.

CONCLUSION

It is therefore important for foreign buyers to make a prudent and comprehensive identification and assessment of risks in Indian M&A transactions. The diligence process should be carefully coordinated by the buyers' counsel with the sellers and the target company to ensure that no party is subject to information asymmetry in relation to relevant information. It is also practical to disclose or identify risks prior to the transaction, negotiate and factor such risks into the transaction to the extent possible. The process for rectification of cross-border disputes arising from issues identified after consummation of the transaction are cumbersome and expensive for all parties involved.

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