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Highlights

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I Deferment of consideration and Seller indemnity permitted under Automatic Route

With a view to simplify business concerning share-purchase transactions involving foreign investment, the Reserve Bank of India (RBI) on May 20, 2016 notified amendments in the Foreign Exchange Management (Transfer Or Issue Of Security By A Person Resident Outside India), 2000 **('Principal Regulations')** by Foreign Exchange Management (Transfer Or Issue Of Security By A Person Resident Outside India) (Seventh Amendment) Regulations, 2016. This amendment allows, under the automatic route, the deferment in payment consideration under an escrow mechanism and permits seller to give indemnity in respect of share-purchase transactions involving foreign investment. Under the erstwhile regime of foreign investment under automatic route, the deferment of purchase consideration was not permitted. Escrow mechanism was for indemnity obligations was not provided for in the Principal Regulations and any such escrow required RBI approval.

In the Principal Regulations, Regulation 10A has been inserted which reads as following:

"10A. In case of transfer of shares between a resident buyer and a non-resident seller or vice-versa, not more than twenty five per cent of the total consideration can be paid by the buyer on a deferred basis within a period not exceeding eighteen months from the date of the transfer agreement. For this purpose, if so agreed between the buyer and the seller, an escrow arrangement may be made between the buyer and the seller for an amount not more than twenty five per cent of the total consideration for a period not exceeding eighteen months from the date of the transfer agreement or if the total consideration is paid by the buyer to the seller, the seller may furnish an indemnity for an amount not more than twenty five per cent of the total consideration for a period not exceeding eighteen months from the date of the payment of the full consideration:

Provided the total consideration finally paid for the shares must be compliant with the applicable pricing guidelines."

The following aspects are being introduced by the amended regulation:

(i) Provision related to deferred payments:

The amendment allows deferment of purchase consideration in share purchase transactions involving foreign investment (inbound and outbound). This deferment can be up to a maximum of 25 (twenty five) percent of the total amount of consideration as specified under the purchase agreement. The time period for which this deferment is allowed is for a maximum duration 18 (eighteen) months from the date of definitive agreement.

It is noteworthy that the reference date for commencement of the 18 months period for deferment mechanism is the execution date i.e. the date on which the share-purchase agreement was entered into and not the Closing date i.e. the date on which the seller transfers his shares to the purchaser and the consideration is paid by the purchaser for the same and vice versa.

(ii) Provision for escrow account.

Pursuant to the amendment, both the parties to the transaction can enter into an agreement for escrow mechanism and open an escrow account. This account has to be opened in India. This escrow amount can be up to a maximum of 25 (twenty five) percent of the total amount of transaction. The time period for which this deferment is allowed is for a maximum duration 18 (eighteen) months from the date of definitive agreement.

The flexibility conferred by the RBI through this amendment in the provisions of escrow account has several merits, namely, facilitating the purchaser in securing its indemnity rights; providing an effective remedy in case the purchaser decides to act against the breach of warranty by the seller; holding of consideration by the purchaser in the escrow mechanism would facilitate 'post-closing purchase price adjustment', etc.

(iii) Indemnity by seller.

The amendment also throws light on the circumstances in which the purchaser has paid complete consideration to the seller. In this case, the seller shall provide indemnity to the purchaser for a maximum period of 18 (eighteen) months. However, the indemnity can only be for a maximum amount of 25 (twenty five) percent of the total consideration of the share-purchase transaction. This indemnity shall commence from the date of "closure" or the date on which the seller transfers his shares to the purchaser and the consideration is paid by the purchaser for the same.

In all the cases, the total consideration finally paid for the shares must be compliant with the applicable pricing guidelines prescribed by RBI.

VA View

Deferred consideration mechanism and indemnity escrows form an integral part of the mergers and acquisition transactions and play an important role in structuring the transaction. The amended regulation caps the indemnification amount in share transfer agreements at 25% of total consideration and time period for claiming indemnification is capped at 18 months.

Currently, in most share transfer agreements between residents and non-residents for sale and purchase of shares there are indemnification provisions for breach of representations, warranties and covenants. The cap on indemnification could vary from 25% to 100% of the consideration and is generally unlimited for representations relating to title of shares, authority to execute, etc. Similarly the time period for validity of indemnities could vary from 12 months to limitation period available under applicable law. For tax indemnities, time period for indemnification could be 7 to 8 years. Parties do not approach RBI for approval whilst signing share purchase agreements but will approach RBI for approval for remittance if at all an actual indemnification claim arises.

In case of share purchase agreements (i) where the indemnity provided for breach of representations, warranties and covenants exceeds 25% of consideration or (ii) where the time period for claiming the indemnity exceeds 18 months, it is not clear if the parties should approach RBI for approval at the time of signing of the share purchase agreement or as and when the indemnification claim arises.

However, this amendment by the RBI is a welcome and a much necessary step towards ensuring some protection for purchasers in cross-border transactions.

II. Supreme Court imposes exemplary costs on parties for loss of judicial time on unscrupulous litigation

The Supreme Court in the case of Messer Holdings Ltd. vs. Shyam Madanmohan Ruia and Ors. (decided on April 19, 2016) **("Messer 2016 case")** came down heavily on the parties and imposed exemplary costs for wasting judicial time on litigation which could have been avoided. The apex Court did not express any definitive opinion on certain issues related to share transfer agreements as outlined below.

Before turning to the facts and decision in Messer 2016 case, it will be relevant to briefly consider two important cases decided by the Bombay High Court, namely, (i) Messer Holdings Limited vs. Shyam Madanmohan Ruia and Ors. and Goyal MG Gases (P) Limited vs. Shyam Madanmohan Ruia and Ors. (decided on September 1, 2010) **("Messer 2010 case");** and (ii) Bajaj Auto Ltd. vs. Western Maharashtra Development Corporation Ltd. (decided on May 8, 2015) **("Bajaj Auto case").** In Messer 2010 case, the Bombay High Court observed that Section 111A of the Companies Act, 1956 (which inter alia, provides that shares or debentures and any interest therein of a company shall be freely transferable) does not expressly restrict the right of shareholders to enter into consensual arrangement/agreement in respect of shares held by them. In the Bajaj Auto case, a Division Bench of the Bombay High Court, inter alia, concurred with the view taken in Messer 2010 case and reiterated that a shareholder of a public company can arrive at a consensual agreement/arrangement (either by way of sale, pledge, pre-emption etc.) with a third party or another shareholder, which is in conformity with the Articles of Association, the Companies Act and rules, and any other governing laws. The Bombay High Court also made a note of Section 58 of the Companies Act, 2013 which now explicitly provides that any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract. It may be noted that the other High Courts like the Delhi High Court have adopted a different view on this matter.

The Bombay High Court in Bajaj Auto case also considered several other judgments including the judgment of the Supreme Court in V.B. Rangaraj vs. V.B. Gopalakrishnan and others (decided on November 28, 1991), where the Court had observed that the agreement which imposes additional restrictions on the member's right to transfer his shares which are contrary to the provisions of the articles are not binding either on the shareholders or on the company. In M.S. Madhusoodhanan and Anr. vs. Kerala Kaumudi Pvt. Ltd. and Ors. (decided on August 1, 2003), Supreme Court distinguished the decision in V.B. Rangaraj's case (supra) and opined, inter alia, that the parties who had consciously entered into the agreement regarding the transfer of their parents shares are obliged to act in terms of the agreement. It may be noted that these cases involved private companies.

In Messer 2016 case, which was an appeal to decision in Messer 2010 case, the Supreme Court has not mentioned any view in respect of restrictions on share transfer. In this case, the apex Court made note of several litigations pending in various Courts. The Court made stern observations that almost a period of 18 years had been spent on litigation, the conduct of none of the parties to the litigation was wholesome and therefore refused to express its opinion, blaming and holding the parties responsible for such long- drawn out litigation. The Court imposed exemplary costs of ₹ 25,00,000/- (Rupees Twenty Five Lakhs only).

VA View

As the judgment in Messer 2016 case does not contain any definitive view in respect of restrictions on share transfer, one would have to wait for the decision in the appeal [SLP (Civil) 27194-27195 of 2015] against judgment of the Bombay High Court Division bench in the Bajaj Auto case pending before the apex court. However, it is to be noted that uncertainty has been laid to rest partially by the provision in the Companies Act, 2013 which expressly provides that any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract.

III. National Company Law Tribunal constituted

The Ministry of Corporate Affairs **("MCA")** has notified certain key provisions relating to National Company Law Tribunal **("NCLT")** and National Company Law Appellate Tribunal **("NCLAT")** under the Companies Act, 2013 ("2013 Act"), constituting NCLT and NCLAT with effect from June 1, 2016.

NCLT and NCLAT are now constituted with effect from June 1, 2016 by MCA notification dated June 1, 2016. Government has constituted eleven benches of NCLT in ten cities across the country to exercise jurisdiction over the area as specified by another notification dated June 1, 2016. From June 1, 2016, all matters pending before the Company Law Board stand transferred to the NCLT.

With the constitution of NCLT and NCLAT, MCA simultaneously notified certain provisions of 2013 Act by notification dated June 1, 2016 which could not come into force for long time as the NCLT and NCLAT had not been constituted.

Provisions regarding oppression and mismanagement are now notified, which may open the floodgates of litigation in this area before NCLT. It is to be remembered that NCLT has been given wider powers to deal with cases of oppression and mismanagement under the 2013 Act by giving it discretion to waive (i) the requirement of minimum number of shareholders required to make an application; (ii) the requirement for establishing existence of 'just and equitable' circumstances; and (iii) the requirement of providing 'security' while allowing such an application.

The 2013 Act also granted additional powers which can be exercised by NCLT while making orders in case of oppression and mismanagement such as:

(a) restrictions on the transfer or allotment of the shares of the company;

(b) removal of the managing director, manager or any of the directors of the company;

(c) recovery of undue gains made by any managing director, manager or director during the period of his appointment and the manner of utilisation of the recovery including transfer to Investor Education and Protection Fund or repayment to identifiable victims;

(d) the manner in which the managing director or manager of the company may be appointed subsequent to an order removing the existing managing director or manager of the company;

(e) appointment of such number of persons as directors, who may be required by the NCLT to report to the NCLT on such matters as the NCLT may direct; and

(f) imposition of costs as may be deemed fit by the NCLT.

Another important provision notified is Section 245 of the 2013 Act which provides for class action suits, a completely new introduction under the Act. Such number of member or members, depositor or depositors, as specified in said Section can now file an application before NCLT on behalf of the members or depositors for seeking orders such as to restrain the company from committing an act which is ultra vires the articles or memorandum of the company, to restrain the company from committing breach of any provision of the company's memorandum or articles, to restrain the company from taking action contrary to any resolution passed by the members, etc. if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company or its members or depositors.

VA View

Constitution of NCLT will surely usher in a new era in company law enforcement and adjudication in the country.

It is pertinent to note that with regard to cases of oppression and mismanagement, certain powers of the NCLT under the 2013 Act have not been notified such as power of NCLT to provide for consequent reduction of company's share capital in case of purchase of its shares by the company under clause (c) of sub-section (2) of Section 242 and to order setting aside of any transfer, delivery of goods, payment, execution or other act as per clause (g) of sub-section (2) of Section 242.

However, there are identical provisions in the Companies Act, 1956 conferring such powers on the NCLT which are not expressly repealed. Thus, there is a lack of clarity on the purpose proposed to be served by not notifying the said provisions of the 2013 Act.

IV. Equalization Levy Tax (Google tax)

As the economy is on the digital frontier and is evolving at a rapid pace, it has become essential for developing nations to formulate a tax framework to bring within its purview the taxation of digital transactions. "Equalisation levy" or what is popularly known as "Google Tax" was introduced in the recent Finance Act of 2016 (**"the Act"**) with an objective to tax digital business to business (B2B) cross border transactions. The provisions relating to imposition and collection of Equalisation levy incorporated as Chapter VIII of the Act comes into force from the 1st of June, 2016. Subsequently, the Central Board of Direct Taxes notified the Equalisation Levy Rules 2016 which enumerates the procedural framework for the implementation of this levy.

As per the Chapter VIII of the Act, an Equalisation levy at the rate of 6 (six) per cent is charged on the amount of consideration for any specified service received or receivable by a person being

1) A person resident in India and carrying on business in India.

2) A non- resident having a permanent establishment in India.

In order to avoid double taxation, a new clause (50) has also been inserted in section 10 to provide that any income arising from specified services provided on or after the date on which the provisions of Chapter VIII of the Act comes into force and chargeable to equalisation levy under that Chapter shall be exempt. The Chapter VIII of the Act defines "specified service" to mean an online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement. Further the Central Government may notify any services that may be considered as specified service under the said definition.

The subjects of this levy are the non-resident service providers. The Act carves out three exceptions when a non-resident shall not be charged, namely,(i) if the non-resident providing such specified services, has a permanent establishment in India; (ii) if the aggregate amount of such services received or receivable does not exceed Rupees

100,000; or iii) where such amounts received are not for the purposes of carrying out business or profession.

Further, the compliance obligations are to be shouldered by the Indian resident who is availing such specified services. The Act provides for furnishing a statement by the assessee in respect of all specified services during such financial year.

Penalty in case of non- compliance:

The Act has also brought penalty provisions for ensuring stricter compliances. Such penalties include interest and fines for failure to file statements or failure to deduct or deposit after deduction of the amount of Equalisation levy. However, in the event a false statement is filed the person may be subject to imprisonment of a term of up to three years and a fine.

VA View

In view of the challenges faced by India in terms of characterization of income arising from the digital economy as well as the likely difficulties faced in attributing profits under existing rules, Equalisation levy appears to be a solution to all these issues, in the form of a simple, clear and predictable tax rule that unambiguously defines the tax liability of digital enterprises, reduces their tax risk and contingent liabilities, and minimizes disputes. It would be a definite step forward for the Indian economy if successfully implemented. Equalization levy has been recognized and accepted in the BEPS Report on Action 1 as one of the options that can be resorted to by countries under their domestic laws. It brings India at par with international taxation practices and most importantly secures huge amount of revenue for India. One of the noticeable developments is that like in the past for imposition of similar taxes on transactions, like the Securities Transaction Tax, the Service Tax, the government has recognized the advantage to keep the Equalisation levy separate from the Income Tax Act. However, the adverse impact it will have on online start-ups cannot be overlooked.

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