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M&A- AMENDMENT TO FEMA REGULATIONS ON DEFERRED CONSIDERATION

Towards further liberalizing foreign investment norms in India and maximizing operational convenience, the Reserve Bank of India ('RBI') has vide a Gazette Notification (*No. FEMA 368/2016-RB dated May 20, 2016 ('2016 Notification')*), made certain significant amendments in the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, relating to payment of deferred consideration on transfer of shares from residents to non-residents and vice-versa, and related escrow arrangements.

In related developments, the RBI had in its *Bi-monthly Monetary Policy Statement, 2016-17 issued on April 5, 2016 and a Press Release dated February 2, 2016*, announced its intention of permitting receipt of consideration amounts on deferred basis, and escrow arrangements and/or indemnity arrangements up to a period of 18 months, on transfer of ownership of start-up enterprises or investments by foreign venture capital investors (FVCIs) in start-ups. However definite guidelines in this regard have not as yet been issued by the RBI.

Key Amendments: The change brought about vide the 2016 Notification viz-a-viz the earlier position on deferred consideration and escrow arrangements on transfer of shares between resident buyers and a non-resident sellers, or vice-versa, is dealt with below.

Particulars	Position prior to the 2016 Notification	Revised Position under 2016 Notification
Deferment of Consideration	In terms of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) (Sixth Amendment) Regulations, 2012 as incorporated in Para 8B(IV)(i) of Master Circular on Foreign Investments in India dated July 30, 2015 (' 2015 Master Circular '), transfer of shares or convertible debentures from residents to non-residents by way of sale requires prior approval of RBI in case of any deferment of payment of the amount of consideration.	Up to a maximum limit of 25% of the total consideration could be paid by the buyer on a deferred basis within a period of 18 months from the date of the transfer agreement. Provided the total consideration must be compliant with the applicable pricing guidelines.
Escrow Account in relation to deferred consideration	In terms of 2011 Circular, in case the escrow account is required to be maintained beyond 6 months from the date of opening up of such account, specific permission from the RBI will be required. <i>Before the 2011 Circular was effective, escrow accounts on behalf of non-resident corporate entities for acquisition of shares and/or convertible debentures of Indian companies through open offer/delisting/exit offers was permitted, subject to compliance with applicable SEBI regulations. In all other cases, prior approval of the RBI was required.</i>	Buyer and Seller may enter into an escrow arrangement for an amount not more than 25% of the total consideration for a period of 18 months or less from the date of the transfer agreement.
Escrow account in relation to securities	In terms of 2011 Circular, in case the escrow account is required to be maintained beyond 6 months from the date of opening up of such	The current 2016 Notification is silent on this.

Indemnity Sellers	by	account, specific permission from the RBI will be required.	If the total consideration is paid by the buyer to the seller, the seller may furnish an indemnity for an amount up to a maximum limit of 25% of the total consideration for a maximum period of 18 months the date of the payment of the full consideration.
		The extant regulations were silent of this	

ARA LAW View

While the 2016 Notification should facilitate more desirable structuring in cross-border transactions, there are few questions that it has been left open. These are dealt with below:

Deferment of consideration without opting for escrow mechanism : In terms of Para 8B(IV)(i) of the 2015 Master Circular, prior approval of the RBI is required for any deferment of consideration. However, the 2011 Circular did away with the requirement of RBI approval where **such deferment was subject to an escrow mechanism** for a maximum period of 6 months from the date of opening of such account. The question therefore arises as to whether, under the erstwhile regime, transactions structured to have deferred consideration payable within a maximum period of 6 month but not involving an escrow arrangement, still required prior RBI approval.

The 2016 Notification also appears to have left this question unanswered as it has not been made abundantly clear on whether the non-requirement of prior RBI approval in transactions involving deferment of consideration up to 18 months is strictly subject to an escrow mechanism.

Calculation of time period of 18 months : The 2016 Notification provides that the consideration could be deferred for a period of 18 months from the date of transfer agreement instead of the date of opening up of the account or date of share transfer.

Under the 2011 Circular, the time period for which an escrow was permitted without any RBI approval was 6 months from the date of opening up of the account. This shift in position under the 2016 Notification does not appear to take into consideration time gaps between execution of transaction documents and closing (which is when escrow accounts would typically be opened).

Cap on Indemnity : The 2016 Notification provides for indemnification obligation of the seller (whether resident or non-resident) as an alternative to escrow or holdback mechanism in case the total consideration has already been paid by the acquirer. Further, a cap of 25% of the total consideration and a limitation period of 18 months has also been imposed on such indemnification obligations.

Prior to this, there were no such restrictions on indemnification obligations between parties in cross-border transactions which were generally subject to contract between the parties and commercial considerations. The intention behind the restriction on indemnification obligations of sellers under the 2016 Notification is unclear and may have significant impact on deal making.

Conclusion : While the amendments under the 2016 Notification appear to have been made with the intention of boosting the FDI and cross-border transaction climate in India, there are several issues that it leaves unanswered. In the absence of suitable clarifications from RBI addressing these issues, the desired effect that it seeks to have may not be achieved.

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