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JOINT VENTURES IN INDIA

Introduction

Foreign investment for development has become a matter of necessity for most growing economies in the world. India is no different. An emerging market implies a market which is deregulated and has conditions favourable to foreign investment. Although India falls within this category, the term, "emerging market" has not been legally defined. In several industrial sectors, the Government of India has felt that the best way forward is to permit foreign investment. In 1991, the Indian Government amended the New Industrial Policy, whereby many industrial sectors, hithertofore closed, were opened up for investment. Since then, the Government has not looked back, and presently in many areas foreign corporations are allowed to incorporate wholly (100%) owned subsidiaries ("WOS") in India. Furthermore, the Indian capital markets have also been liberalised. Today, foreign institutional investors ("FIIs") operate in the Indian stock markets, providing a variety of services.

A joint venture is generally understood as technical and financial collaboration either in the form of greenfield projects, take-overs or alliances with existing companies.[i] In India, no legal definition as such has been given to joint ventures. However, the Government of India and its agencies prescribe certain guidelines, which distinguish joint ventures from other entities. Indian joint ventures usually comprise two or more individuals/companies, one of whom may be non-resident, who come together to form an Indian private/public limited company, holding agreed portions of its share capital. A joint venture agreement, primarily provides for the manner in which the shareholders of the joint venture company may transfer or dispose of their shares. It is also commonly referred to as a shareholders agreement.[ii]

Pre-formation considerations

The key pre-formation considerations can be summarised as under:

The industry in which investment is being made

In certain areas such as telecommunications, drugs & pharmaceuticals, hotel & tourism, or advertising foreign investment up to 50%, 51% and/or 74% in the equity of a joint venture company is permitted without Reserve Banc of India (RBI) approval. However, should the foreign investor seek to subscribe to more than 74% of the total equity in a joint venture company or establish a WOS, permission has to be obtained either from the Foreign Investment Promotion Board ("FIPB") or the Secretariat of Industrial Approvals ("SIA") depending upon the quantum of investment. Applications for large investments and WOSs are entertained only by the FIPB. Moreover, in case of FIIs, aggregate portfolio investments in the share capital of Indian companies is permitted to the extent of 24% of the issued and paid-up capital of the company. However, an Indian company may permit a FII to purchase up to 30% of its share capital by passing a special resolution (resolution required to be passed by shareholders having 75% shares with voting rights in the company).[iii]

It should be highlighted that the aforesaid is applicable to foreign companies and individuals only. Should the investment be made by non-resident Indians (Indian citizens living abroad or persons of Indian origin living abroad and having foreign nationality), the investments laws are more relaxed. Since the focus of this paper is to describe joint ventures in India involving foreign companies and/or foreigners, investment laws relating to NRIs have not been discussed.

Control in the joint venture company

Under the Companies Act, 1956, ("CosAct") a company can carry on activities by passing either of two resolutions, special resolutions and ordinary resolutions. Ordinary resolutions can be passed by shareholders having 50.01% (rounded of to 51%) shares with voting rights in the company, whereas special resolutions can be passed only by shareholders having 75% shares with voting rights in the company. A special resolution is inter alia required to amend the Memorandum and Articles of Association of a company, to issue further shares through a rights issue, to give loans or guarantees to other companies, etc. 51% majority ensures control of the day to day working of the company. Therefore, much depends on the level of control the foreign investor seeks. Normally, Indian joint ventures have a 51%-49% equity break-up between the foreign and Indian partners, respectively.

Indian partner's ability to invest

The investments (cash or otherwise) being made by the parties are also relevant. Generally, foreign companies are the main investors in joint ventures. Therefore,

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they seek higher equity percentages. However, larger Indian companies, who are in a position to make substantial investments, often seek quid pro quos. "Who brings what to the table," decides the equity ratio in many cases.

Tax considerations

In many instances, companies route their investments into an Indian joint venture company through an offshore destination. India has double taxation avoidance agreements ("DTAAs") with many countries. Many US companies route their investments through the Mauritius islands, because the Indo-Mauritius DTAA has reduced withholding tax rates applicable to capital gains, technical service fees earned in India, etc. Cyprus is another offshore destination gaining popularity.

How do you protect confidential information at the negotiation stage?

In order to protect sensitive business information from being divulged to others, confidentiality and non-disclosure agreements are entered into, prior to commencing negotiations. Indian courts enforce these agreements and grant injunctions on adequate proof of breach or proposed breach being adduced. However, due to systemic delays, suits for damages take a fairly long time to reach hearing. Therefore, although an injunction may be granted urgently, a decree awarding damages to the injured party may take some time.

Formation of a joint venture

India has inherited the English common law system. Under this system, unlike the civil law system, contracts are detailed. Shareholders' agreements and the articles of association (bylaws) of the joint venture company form the basis of the joint venture. The shareholders agreement prescribes share transfer restrictions, if any, which are then incorporated into the articles of association of the joint venture company.

In India, joint ventures can exist in the form of companies, partnerships or joint working agreements. The various companies that may be incorporated in India are as follows:

1. Companies limited by shares

2. Companies limited by guarantee

3. Companies having unlimited liability

Companies limited by shares are of two types - public and private. As regards companies limited by shares, members are liable only to the extent of the unpaid amount on their shares, if any. In a company limited by guarantee, the liability is limited to the amount pledged, being the contribution to be paid in case of winding-up of the company. In companies with unlimited liability, the liability of each member is unlimited. The most common form of joint ventures are Indian public or private companies, wherein share capital is issued to the joint venture partners. In this way, the risk of members is limited to the extent of the unpaid amount on their shares.

The next step is to decide whether to have a public or a private company. Unless money is sought to be raised from the public, joint venture partners do not incorporate public companies.[iv]

In India, partnerships are defined under section 4 of the Indian Partnership Act, as agreements to enter into a partnership business so as to share profits and to conduct such business for one or on behalf of all. Partnerships do not have any limitations on liability of the respective partners. Thus, the risk associated with this form of business is very high, and is not advocated for any type of joint venture.

Joint working agreements are either customer or market oriented depending upon the needs of the partners. In joint working agreements, the domestic partner manufactures those components which are cost effective while the joint venture partner imports into India those components which are not cost effective to manufacture. The final product is a result of the melange. In case of joint working agreements, there may not be a complete transfer of technology. Technology transfer may proceed gradually in steps. There is no payment of lump sum fee or royalty to the foreign company. There is a gradual sharing of revenue between the parties.

Due to the limited liability advantages, most parties to a joint venture in India go in for legal entity, i.e., a public or private company.

Foreign companies not wanting to tie up with an Indian partner, may establish liaison, branch or project offices, or WOS. Indian law does not recognise the American limited liability companies and limited liability partnerships.

Indian law affords parties to a joint venture agreement a high level of flexibility, and so long as a joint venture agreement is not contrary to public policy, it will be enforceable. In order to make the joint venture agreement valid in law, the requirements prescribed by the Indian Contract Act[v] and the CosAct need to be met. Some of the important criteria to be fulfilled are:

a) Offer and acceptance,

b) Consideration,

c) The intention to form a company, and

d) Signature of the parties

Other important provisions in joint venture agreement are:

a) Constitution of the board of directors,

b) Termination clause,

c) The binding nature of the agreement,

d) Share transfer provisions,

e) Dilution clause, and

f) Dispute resolution clause

For the joint venture agreement to be enforceable, parties have to pay a particular amount by way of stamp duty on the joint venture agreement.[vi] Joint venture agreements have to be registered either with the RBI or the SIA, depending on which authority gives clearance for the project. No registration is required under the Indian Registration Act, unless the joint venture agreement deals with transfer of immovable property rights.

There is no bar on the appointment of a trustee or nominee to hold shares on behalf of a foreign shareholder in the joint venture company. Sections 153, 153-A, 153-B and 187-B[vii] of the CosAct deal with trustees and their functioning. Section 49(2)of the CosAct deals with appointment of nominee shareholders.

Division of power

Under Indian law, it is possible to reach a perfect balance of power between the joint venture partners. Everything depends on the control sought to be exercised by the partners and capital being infused in the joint venture. Naturally, a joint venture partner bringing in proprietary technology or capital will seek control.

The articles of association, incorporating the key provisions of shareholders agreement, provide for control of the joint venture company. The exercise of control is done at two levels:

1. Board of directors

2. Shareholders

The shareholders agreement prescribes the number of directors on the board, the quorum for board meetings and general meetings, the day to day management of the company, procedure to be followed on the death or bankruptcy of a joint venture partner, etc. In order to prevent deadlocks, the chairman of the board of directors can be given a casting vote in case of equality of votes on the board. Foreign companies usually retain the right to appoint the chairman per meeting of the board. If for some reason this does not work, deadlocks can be solved by resorting to alternate dispute resolution such as conciliation and/or arbitration.

Under Indian law, companies can perform various acts by passing resolutions (special or ordinary) as prescribed in the CosAct. As provided above, if a shareholder has 51% majority on the board and in the joint venture company, he can pass ordinary resolutions binding on the company. Most promoters strive for 75% equity which gives them full power to perform all activities.

In case of bankruptcy of one of the partners, joint venture agreements commonly provide that the agreement may be terminated. On death of a partner, devolution of shares in a particular manner or termination are the two options.

In ordinary circumstances, the joint venture is run by the board of directors upon whom powers are delegated by the articles of association.

Division of proceeds

Except for section 205 of the CosAct, which provides for distribution of dividend, there is no codified law in India, which regulates the division of proceeds. Restrictions on profit sharing or payment of dividends are included in the shareholders agreement. Once Government of India permission is granted to the foreign investor to invest in an Indian joint venture company, the foreign investor can repatriate both, the principal as well as dividend or other income without any restrictions. Currently, dividends in India are not taxable in the hands of the shareholders. The company has to pay tax @ 12.5% (plus surcharge and education cess) on the dividend to be distributed to the shareholders.

A <u>sample clause</u> in this regard is as follows:

The Board of Directors shall have the right to determine the issuance of dividends, except that:

(i) No dividends shall be paid during the first two (2) years of this Agreement; and

(ii) Dividends will be paid only if the return on equity for the preceding fiscal year was fifteen percent (15%) or greater. Such dividends will be limited to ten percent (10%) of after tax profit for the preceding fiscal year.

Transfer of shares

There are no statutory rules to be followed as regards transfer of shares. The transfer conditions depend upon the joint venture agreement. However, to effect a transfer the shareholders must execute a share transfer form and furnish it along with the original share certificate to the company. It should be pointed out that under section 111 of the CosAct, a company has the power to refuse the registration of transfer of shares. Each refusal must be accompanied with specific reasons. Appeal against such refusals lie to the Company Law Board. This provision is often used for blocking share transfers. Therefore, care must be taken to contract out of this provision or to provide for detailed restrictions in the shareholders agreement, to be copied in the articles of association, verbatim.

A sample clause is as follows:

If X and/or Y desire to sell/transfer all or any part of their shares in the new company, they shall first offer such shares to the other, if only one of them seeks to sell/transfer their shares. In the event that neither wants to buy the shares offered by the other within 20 days of the offer being made or both want to sell simultaneously, they shall offer the shares to Z. In the event that Z does not want to buy the shares within 20 days of the offer being made to him, they shall offer the shares to a third party.

If Z desires to sell or transfer all or any part of his shares in the new company, he shall first offer such shares to X and Y in proportion to their shareholding in the company.

If X and/or Y decline to accept such a first offer in whole or in part, within 30 days from the making of the offer, then Z may offer the shares thus declined to his family members/relatives or other third parties at the same price.

The price for sale/transfer of shares will be arrived at by valuing the shares. The valuation of the shares will be done by an independent valuer to be appointed by the Board of Directors of the new company.

An offer for transfer of shares provided in this Article shall be made in writing setting forth the number of shares to be transferred, time of transfer, price of the shares as determined by the valuer, and other conditions, if any.

In case of termination of this Agreement, any party desirous of continuing the company independently has an option to purchase the shares owned by the other party within 5 days from the date of notice of termination or otherwise, at a price to be calculated in accordance the relevant paragraph stated above.

The context of this clause shall be incorporated in the Articles of Association of the new company to the extent that law permits.

Any sale/transfer between/or to X and Y will be subject if applicable, to such terms, conditions and price as approved by the Government of India/Reserve Bank of India.

One can make out from this sample clause that no new member can be introduced into the company without the permission of the other partners. The articles may also provide for an absolute prohibition to transfer shares to other parties, which is very common in case of private companies.

In order to prevent a major shareholder from leaving immediately, the shareholders agreement can provide for a lock-in period.

A sample clause is as follows:

Restriction Against Transfer. None of the parties shall transfer or otherwise dispose of [as defined in Section 16(c)] all or any Shares [other than to an affiliate {as defined in Section 16(d)}] during the first four (4) years of the term of this Agreement. Thereafter, none of the parties shall transfer or otherwise dispose of all or any Shares without the written consent of 75% of the outstanding Shares of the Corporation, except as otherwise expressly provided in Section 2.

A perusal of this clause shows us that a time period may be specified, only on completion whereof a joint venture partner can sell and transfer his/her shares.

Regulatory restrictions/approvals

All joint venture proposals not falling within the Reserve Bank of India's automatic route require approval of the Reserve Bank of India, the FIPB or the concerned industry ministry, depending upon the quantum and nature of foreign investment. There is no way in which regulatory restrictions can be avoided.

Having acted for several companies from industrialised jurisdictions, it is imperative to make a good written proposal of the project to be followed up with oral presentations. The FIPB can be complicated. If all else fails, the *speed money* approach may be attempted.

Permissions granted by RBI and FIPB are valid for two years. Every six months, a statement is required to be submitted to the SIA as regards the status of the project and the amount of money invested. If the parties fail to take steps as per the permission letter, the permission may not be renewed on expiry of the two year period.

Usually, joint venture partners cannot enter into activities competing with the joint venture. Shareholders agreements contain specific provisions in this regard. Non-compete provisions can be validly enforced even after a member leaves the joint venture so long as they are reasonable and not against public policy.

A sample clause is as follows:

During the term of this agreement, neither party shall have any ownership interest (of record or beneficial) in or have any interest as an employee, salesman, consultant, officer or director in, or otherwise aid or assist in any manner, any person or company or firm that engages in Goa in a business which is similar to that undertaken by the parties in this agreement.

During the term of this agreement and for a period of two years thereafter, no party shall solicit or assist any other Person to solicit any business (other than for the new company) from any present or past customer of the new company; or request or advise any present or future customer of the new company or any of its Affiliates, to withdraw, curtail or cancel its business dealings with the new company or any of its Affiliates; or commit any other act or assist others to commit any other act which might injure the business of the new company or any of its Affiliates.

During the term of this agreement and for a period of two years thereafter, no party shall directly or indirectly (i) solicit or encourage any employee of the new company or any of its Affiliates to leave the employ of any such entity or (ii) hire any employee who has left the employment of the new company or any of its Affiliates if such hiring is to occur within one year after the termination of such employee's employment with the new company or any such Affiliate.

During the term of this agreement, no party shall directly or indirectly solicit or encourage any consultant then under contract with the new company or any of its Affiliates to cease work with such entity.

If any party breaches, or threatens to commit a breach of, any of the Restricted Covenants, the parties shall have the following rights and remedies, each of which rights and remedies shall be in addition to, and not in lieu of, any other rights and remedies available to the parties under law or in equity:

(a) The right and remedy to have the Restrictive Covenants specifically enforced by any court having equity jurisdiction, all without the need to post a bond or any other security or to prove any amount of actual damage or that money damages would not provide an adequate remedy, it being acknowledged and agreed that any such breach or threatened breach will cause irreparable injury to the new company and that monetary damages will not provide adequate remedy to the new company; and

(b) The right and remedy to require such party (i) to account for and pay over to the new company all compensation, profits, monies, accruals, increments or other benefits derived or received by such Former Venturer or any associated party deriving such benefits as a result of any such breach of Restrictive Covenants; and (ii) to indemnify the new company and/or its nominees against any other losses, damages (including special and consequential damages), costs and expenses, including actual attorneys' fees and court costs, which may be incurred by them and which result from or arise out of any such breach or threatened breach of the Restrictive Covenants.

If any court determines that any of the Restrictive Covenants, or any part thereof, is invalid or unenforceable, the remainder of the Restrictive Covenants shall not thereby be affected and shall be given full effect, without regard to the invalid portions. If any court determines that any of the Restrictive Covenants, or any part thereof, is unenforceable because of the duration of such provision or the area covered thereby, such court shall have the power to reduce the duration or area of such provision and, in its reduced form, such provision shall then be enforceable and shall be enforced. Each party hereby waives any and all right to attack the validity of the Restrictive Covenants on the grounds of the breadth of their geographic scope or the length of their term.

Indian law is very strict as regards restrictions on an individual employee from obtaining similar employment on expiry of the term of the contract. Such a clause cannot be enforced. However, parties normally insert most restrictions, even though some may be held invalid at a later stage.

Termination provisions are generally included in the shareholders agreement. India is moving along at a healthy pace in its reforms process and is unlikely to expropriate industries already liberalised. Therefore, it is unlikely that the Government will terminate a joint venture unless there is a breach in the conditions stipulated by the Government.

The Monopolies and Restrictive Trade Practices Act deals with anti-trust matters and unfair trade practices. Normally, it comes into play when exclusive distribution agreements are being entered into or when goods are required to be sold subject to certain conditions. In addition, it prescribes certain practices as unfair trade practices.

Tax and subsidies

Joint venture companies do not per se get advantageous tax treatment. However, the Indian Income Tax Act gives certain benefits to industries set up as 100% export oriented units, or in export processing zones. In addition, infrastructure industries in the areas of power, telecommunications, ports, etc., get tax breaks and rebates. Persons investing in the bonds of such companies do not pay tax on the interest received.

Small scale industries, i.e., industries entailing an investment upto Rs. 10,000,000 (US$ 222,222), get direct and indirect tax benefits.

As regards subsidies, the Government does offer the same to industries set up in backward or rural areas by way of actual cash disbursements, reduced rates for land, etc.

Conflicts and termination of a joint venture

Most joint venture agreements contain clauses prescribing a course of action in case the joint venture fails. Alternate dispute resolution is resorted to on a regular basis. Conciliation/arbitration is common. Arbitration can be conducted outside

India under ICC or other rules. However, RBI and FIPB provide that Indian law must govern the shareholders agreement, where prior approval is required. Therefore, litigation, if any, or enforcement of a foreign award are to be conducted under Indian law in Indian courts. If necessary, courts grant stay orders to prevent the opposite party from disposing of assets of the joint venture company, including intellectual property rights. Anton piller[viii] injunctions are also given by Indian courts.

A sample clause is as follows:

Arbitration

(i) Any controversy between the parties involving this Agreement shall, on the written request of one party served on the other, be submitted to arbitration, and such arbitration shall comply with and be governed by the commercial arbitration rules of the American Arbitration Association in effect on the date of this Agreement. Each party hereby irrevocably agrees that service of process, summons, notice or other communications relating to the arbitration procedure shall be deemed served and accepted by the other party if forwarded in accordance with Section 16(a). The demand for arbitration shall in no event be made after the date when institution of legal or equitable proceedings on such claim, dispute or other matter in question would be barred by the applicable contractual, or other, statute of limitations. The arbitration shall be conducted by three (3) arbitrators familiar with legal issues, to be selected by the parties. If the parties cannot agree on the three within ten (10) days of the service of the notice to arbitrate, then each Shareholder shall select one arbitrator. The arbitrators shall base the decision on the laws of India as reflected in statutes, cases and regulatory law. The procedural laws of the State of Georgia should be used in conducting the arbitral proceeding.

(ii) Unless modified by the arbitrators in their discretion, the arbitration shall proceed upon the following schedule; (i) within ten (10) days from the service of the notice of the demand for arbitration, the parties shall select the arbitrators; (ii) within ten (10) days after selection of the arbitrators, the parties shall conduct a pre-arbitration conference at which the pre-arbitration discovery and pre-arbitration motions shall be scheduled and any other necessary pre-arbitration procedural matters decided; (iii) all discovery shall be completed within twenty (20) days following the pre-arbitration conference; (iv) all pre-arbitration motions

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shall be filed and briefed so that they may be heard no later than fifteen (15) days following the discovery cut-off; (v) the arbitration shall be scheduled to commence no later than ten (10) days after the decision on all pre-arbitration motions, but in any event no later than three (3) months following the service of the demand for arbitration; and (vi) the arbitrators shall agree to hear the claim on successive days and shall render the written decision within fifteen (15) days following the submission of the matter.

(iii) Any monetary award of an arbitrator shall include interest at the rate of ten percent (10%) per annum, which interest shall accrue from and after the thirtieth (30th) day after the initial claim is made until the date the award is paid to the prevailing party. The award rendered by the arbitrator shall be final and binding upon the parties and judgement may be entered in any court having jurisdiction thereof in accordance with applicable law. The losing party shall bear the fees of its and the prevailing party's attorneys, expense of witnesses and all other expenses connected with the presentation of the case. The costs of the arbitration, including the cost of the record or transcripts thereof, if any, administrative fees, and all other fees involved, shall be borne by the losing party, unless the arbitrator otherwise directs.

(iv) All arbitrations conducted under this Agreement shall be held in Atlanta, Georgia. All judicial proceedings to enforce any of the provisions of this Agreement shall take place in Mumbai, India. Each party hereby irrevocably waives, to the fullest extent permitted by law, any objection which it may now or hereafter have to the laying of venue of the arbitration or any action or proceeding arising out of or relating to this Agreement on the ground of forum non coveniens.

In case one partner wants to opt out of the joint venture, it is common to give the other partners the option to buy the stake of the first partner at a price to be fixed after valuation of the shares of the joint venture company.

Conclusion

In conclusion, listed hereunder are the various modes in which a foreign company can do business in India.

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A liaison office can be set up in India. In this way, a foreigner can get a feel of the Indian markets. The actual business is done from the country of incorporation of the parent.

A branch office can be set up in India. A branch has adverse tax consequences (i.e. 40% income tax plus surcharge at 2.5% and education cess at 2%) and is not the most preferred option. However, in areas where joint ventures are not permitted, a branch office is the best solution.

If only one project is being performed in India, the foreign company may consider setting up a project office.

A joint venture company can be set up if the foreign participant wants to collaborate with an Indian partner.

Otherwise, a WOS can be set up.

India is virtually a tax haven for those wishing to set up a manufacturing and export base in India. Therefore, 100% export oriented units either in the form of a WOS or a joint venture should be given due consideration.

References

1. Nabhi, *Manual for Foreign Collaboration and Investment in India*, 1997, p. 72

2. K. Sekhar, *Guide To SEBI Capital Issues, Debentures & Listing*, 1996, p. 3

3. Press note [F14/11/96-NRI] DATED 4-4-1997, ISSUED BY THE DEPARTMENT OF ECONOMIC AFFAIRS

4. A company may want to go public for the following reasons - to harness more funds from the public by way of shares or to get technical assistance by issue of shares to persons with technical expertise. In a joint venture such factors are taken care of by the joint venture partners as they provide all the funds and technical expertise. Joint venture companies normally are private companies. This ensures that the joint venture partners do not loose grip over the company as may happen in a public company.

5. This Act governs contractual relationship between parties.

6. The amount varies from state to state. In the state of Maharashtra the amount is Rs. 100.

7. Section 153 deals with trusts. S.153-B sets out the conditions under which a public trustee is to be appointed. S.153-B states the declaration as to shares and debentures held in trusts

8. Anton piller orders the defendant to allow the plaintiff's named representative to enter and search the defendant's premises in order to to recover property belonging to the plaintiff which the defendant is in possession of. An anton piller orderis done without notice to the defendant.