Navigating Primary and Secondary Cross-border Share Swaps in Indian Mergers & Acquisitions

Commercial and Contracts

Corporate, Securities, and Governance

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Key highlights

- Share swaps are an increasingly popular financing mechanism for mergers and acquisitions in India.
- In-house counsel should understand the key features of the existing regulatory regime.
- The regulatory regimes governing foreign investment by (and overseas investment of) Indian entities present an anomaly regarding the permissibility of cross border share swaps.

Acquisitions in today's merger markets via significant private equity or venture capital investments are typically in two forms, (1) acquisitions across the value chain, and (2) consolidations, both of which traditionally involve cash consideration. In the paradigmatic shift in the commercial world, with the influx of startups, the financing of these acquisitions prefers routing through options that reduce cash outflow, thereby using all-stock or cash and stock considerations.

Share swap arrangements are preferred

Corporate arrangements where two or more companies agree to exchange the equity-based asset of one with that of another such as through a share exchange or stock-for-stock exchange are categorized as a “share swap.” Companies that would like to preserve cash or give an upside to the shareholders of the investee entity are increasingly finding share swaps an attractive option and requiring consequent structuring in the definitive documents proposed between parties to such acquisitions.

In March 2017, for instance, Vodafone Mobile Services Limited and Idea Cellular Limited announced a swap merger based on a share-for-share structure where Vodafone acquired 50.3 percent and Aditya Birla group (which owned Idea) was to be allocated 26 percent of equity in the merger.

More recently, to simplify capital structure and expand turnover, the boards of Jindal Stainless Limited (JSL) and Jindal Stainless (Hisar) Limited (JSHL) approved the merger of JSHL into JSL in a 100:195 share-swap ratio, such that 195 equity shares of JSL were to be issued for every 100 equity shares of JSHL.

The merger of HDFC Limited and its subsidiaries with HDFC Bank created the largest swap, generating a market capitalization of INR 14,000 billion declared earlier this year, whereby equity shares held by HDFC and HDFC Bank will be extinguished per the scheme. As a result, upon the scheme becoming effective, HDFC Bank would be 100 percent owned by public shareholders, and existing shareholders of HDFC would own around 41 percent of HDFC Bank.

Regulatory regime in India

In terms of regulatory compliance, an Indian company issuing shares in a share swap structure, instead of paying cash, is subject to the preferential allotment provisions of the (Indian) Companies Act 2013. Unlisted issuer companies are thus required to *inter alia:*

- Obtain a report from a registered appraiser appointed by the audit committee or board of directors; and
- Convene an extraordinary general meeting of the company’s shareholders, to pass a special resolution obtaining approval from its shareholders to issue shares for consideration other than cash, and make detailed disclosures of the share-swap transaction along with the swap ratio, in the notice calling for the general meeting of such issuing Indian company (See Section 62(1)(c) read with Section 42 of the Companies Act 2013 and Rule 13 of the Companies [Share Capital and Debenture] Rules 2014).

This assumes that the articles of association of the issuing Indian company allow for share issuance for consideration other than cash.

Regulatory regime for cross-border share swaps under India’s foreign exchange laws

India’s foreign exchange policies towards cross-border share swaps were not initially investor-friendly. They mandated (now defunct) Foreign Investment Promotion Board approval. The Reserve

Bank of India (RBI) then amended the Foreign Direct Investment policy in November 2015 and permitted companies operating in sectors falling under the automatic route to issue share swaps without requiring prior government approval.

The Foreign Exchange Management (Non-debt Instruments) Rules 2019 (NDI Rules) permit share-swap transactions against *issuance of equity instruments by the Indian company* to a person residing outside India, conditional upon the valuation involved in the swap arrangement being made by a merchant banker registered with the Securities and Exchange Board of India (SEBI), or by an investment banker outside of India registered with the appropriate regulatory authority in the host country (See Rule 21(2)(c)(iv) read with Clause 1(d)(i) of Schedule I to the NDI Rules). Only primary transactions regarding the shares of the Indian company are permitted in such an arrangement.

Anomaly of interpretation under the NDI Rules and the ODI Regulations

The NDI Rules define "equity instruments" as equity shares, convertible debentures, preference shares, and share warrants issued by an Indian company. As such, it may seem that only the swap of shares between two Indian companies, in which the shareholders of one of these companies are non-resident Indians, may be permitted i.e., a share swap under the NDI Rules is permitted only between two Indian companies.

> The regulatory regime has been undergoing a change, and the government has been open to liberalizing the extant regime from a swap perspective.

However, the Foreign Exchange Management (Overseas Investment) Rules 2022 (ODI Regulations), issued by the RBI in August of this year, provide that an Indian company can make a direct investment outside India, where such investments may be funded, *inter alia*, by way of swap of shares (See Schedules I and III of the Foreign Exchange Management (Overseas Investment) Rules, 2022). The same language as set out under the NDI rules was used under the erstwhile Foreign Exchange Management (Transfer or Issue of Any Foreign Security) Regulations 2004 (Erstwhile ODI Regs, which was superseded by the ODI Regulations in August 2022) to describe the requirement and method of valuation of shares for the *acquisition of shares of an existing company outside India* where the consideration is to be paid fully or partly by issue of the Indian party's shares (i.e., a swap of shares; see Regulation 6(6)(b) and Regulation 6(3)(f) of the Erstwhile ODI Regs).

The ODI Regulations no longer specify any such conditionality on valuation method for investment by way of share swap. The regulatory regime has been undergoing a change, and the government has been open to liberalizing the extant regime from a swap perspective. This allows for more structuring options for companies opting for such swaps, and counsel should evaluate in greater detail before opting for a cash consideration.

Per existing norms, the said arrangement would then simply have to be reported under the ODI Regulations (in Form FC, for a direct investment by an Indian company in a company residing outside India) and under the FDI policy *(*in Form Foreign Currency - Gross Provisional Return) for a direct investment in an Indian company by a company residing outside India.

A primary reading of these legislations indicates an anomaly as to whether a primary issuance under the NDI Rules is permitted in exchange for a secondary transfer under the ODI Regulations. When reading the applicable foreign exchange legislation holistically, however, it appears that the regulatory intent has been to permit such a transaction.

Role of in-house counsel

For now, and until regulators issue a clarification or amend the legislation, investors may consider undertaking transactions where shares of an Indian company are issued against existing shares of a company based outside India, after receiving comfort from their authorized dealer banks regarding the viability and permissibility of such a structured arrangement.

Counsel can consider (1) consulting with their client on the viability of a secondary swap structure and its permissibility under the Indian authorities' latest legal positions in terms of FDI and ODI policy, prior to drafting or executing definitive documents for such structure; (2) checking and fulfilling the different filing requirements for such steps, especially around valuation requirements; and (3) most importantly, ensuring that their authorized dealer bank is on board before executing such structures.

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Vineet Shingal is a Partner in the Corporate and Commercial practice group in the Mumbai office. He has extensive international and cross-border experience, inbound as well as outbound, and has advised several clients on strategic acquisitions, private equity, and venture capital investments, PIPEs, promoter exits and sales (specially on bid situations), corporate restructurings (mergers, demergers, etc), foreign investment laws and general corporate law advisory. Vineet has also advised various start-up and growth-stage companies on investments, especially in the e-commerce space.

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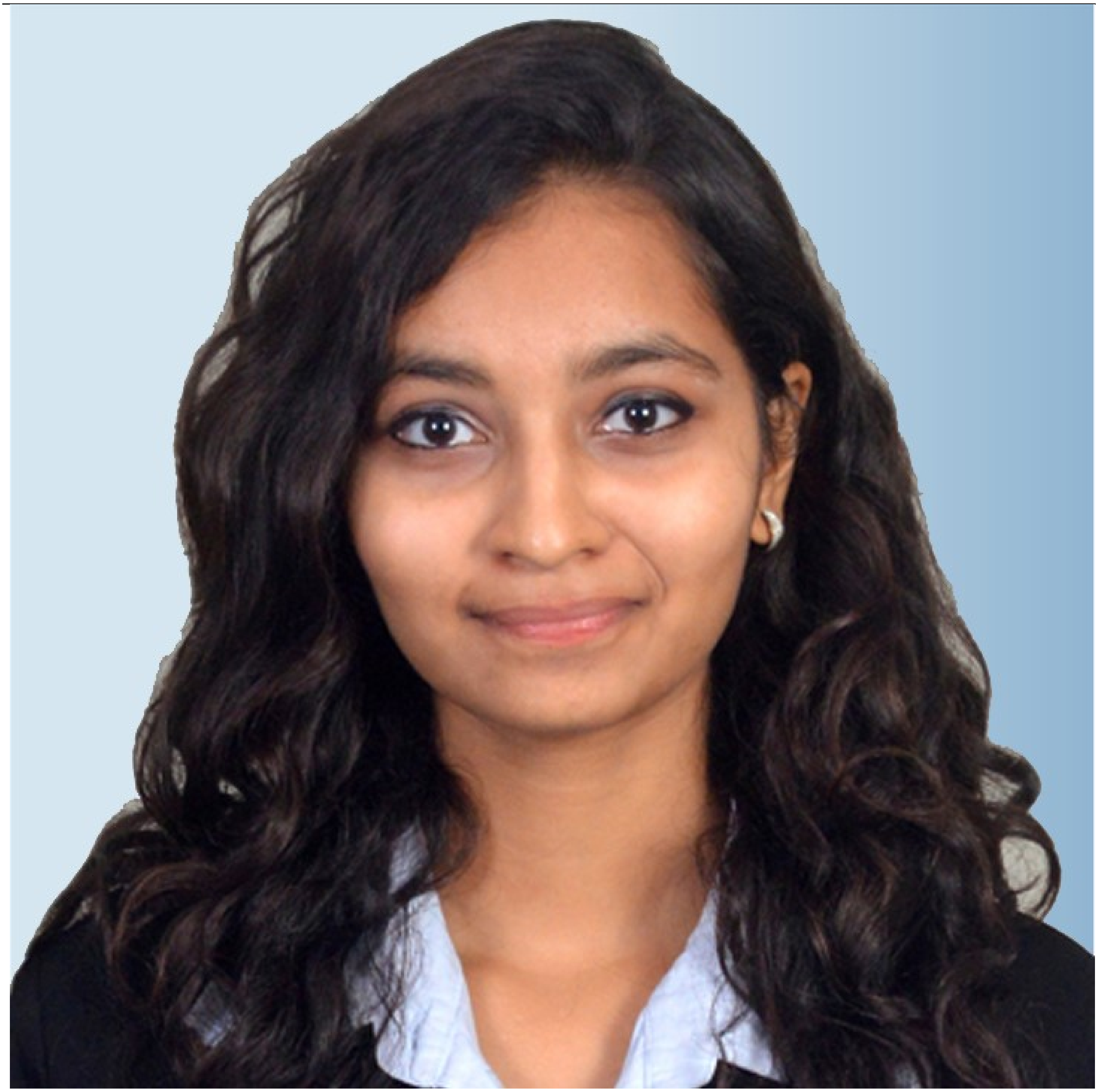

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