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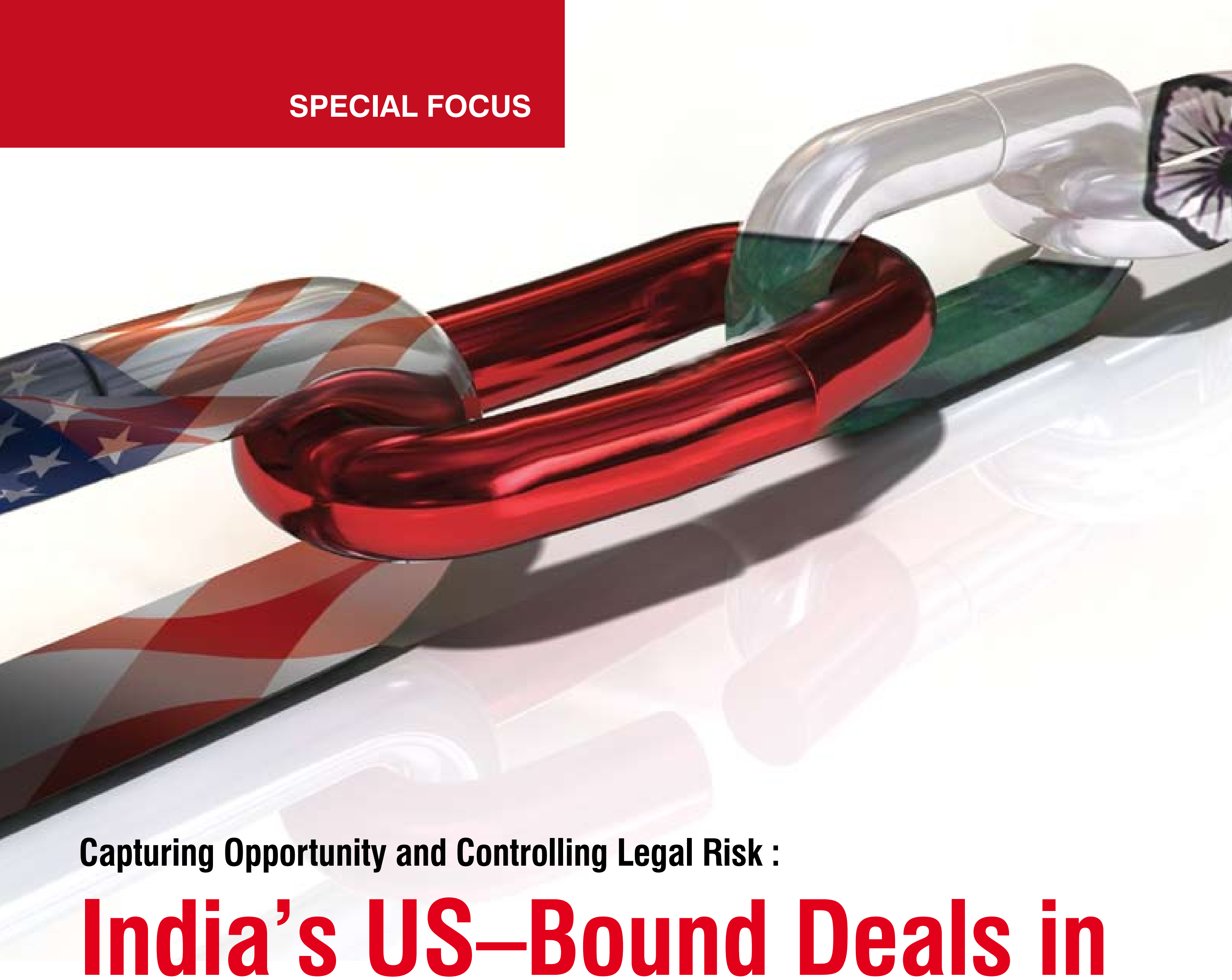

Capturing Opportunity and Controlling Legal Risk :

India's US–Bound Deals in Challenging Times

While Indian outbound foreign direct investment may not immediately continue at a record-setting pace in the current prevailing scenario of uncertainty and pessimism, **David Laverty** says that Indian companies which are recognising that opportunities can be the greatest during such periods are helping to write a new chapter on India's path to globalisation

Indian companies venturing into the rest of the world through acquisitions and other forms of foreign direct investment are making an important contribution to the globalisation of India, even under the currently challenging global economic conditions. While fewer companies have the necessary capital in the short term to aggressively move forward with their outbound investment plans, Indian companies that are savvy in controlling their business and legal risks are taking advantage of outstanding investment opportunities in the United States and elsewhere.

When I met with Indian companies in Mumbai, Bangalore, Delhi and other Indian cities in early 2008 to speak with them about the US legal environment for acquisitions and other forms of investment, the value of the Rupee had been climbing against the US Dollar, Indian labour costs

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had been increasing, favorable Indian outbound investment policy changes were encouraging further outbound growth and many Indian companies were optimistic over their new growth opportunities outside of India.

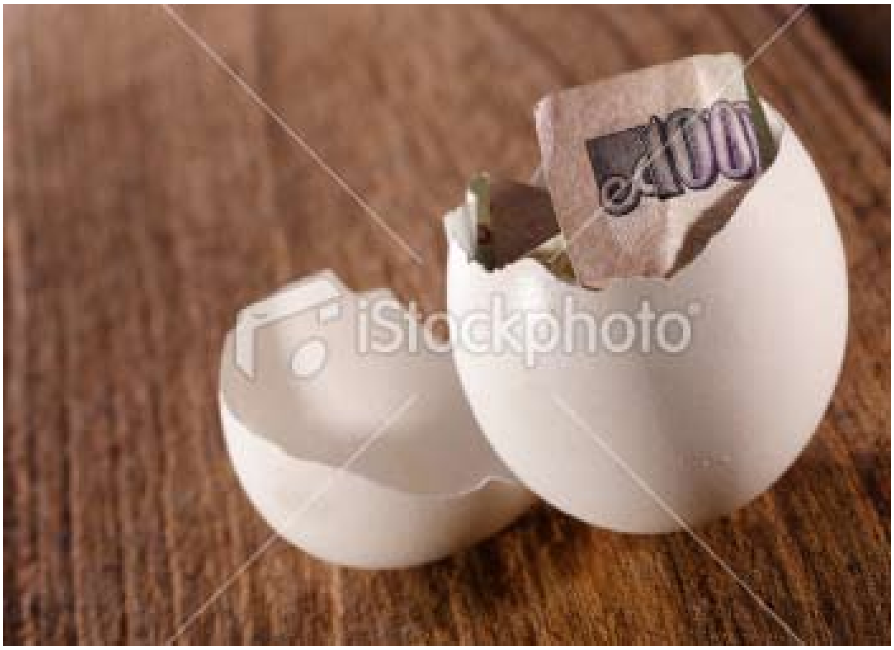
Mid-sized and smaller companies were following the example of major Indian companies in ever-greater numbers, and the levels of 2007 Indian overall outbound investment through acquisition had reached a record of US$32.8 billion over 243 acquisitions. About one-third of this, US$10.6 billion (84 acquisitions) was destined for the US. This was more than three times the US$9.9 billion in 2006 overall volume of outbound Indian acquisitions (190 in number), which was itself two times the US$4.3 billion from 2005 (136 acquisitions). [i]

In the past several months, the global financial crisis has created a different set of challenges and opportunities: Indian overseas investment has become more expensive, as the US Dollar and other currencies strengthen; challenges in financial markets in India and elsewhere have led to the decreased valuation of Indian companies and has created difficulties in accessing capital; difficult credit markets have favoured cash-rich companies due to tight liquidity both in India and overseas; market volatility has created challenges in matching buyer and seller expectations; and the tragic events in Mumbai are just one reminder of the factors outside of our control that can add to a state of uncertainty for cross-border investment into and out of our countries.

The impact has not yet been fully felt, though the total level of Indian outbound investment through November, 2008 stood at US$14.63 billion (190 acquisitions), with US$2.66 billion (69 acquisitions) destined to the US.[ii] At this pace, total 2008 Indian outbound acquisitions will be in the range of one-half of the overall 2007 value and one-third of the 2007 value destined to the US, though note that the numbers of outbound acquisitions have not dropped as dramatically (the value of reported acquisitions can swing more dramatically depending on whether especially large deals are reported during any given period).

Yes, some Indian companies may scale back their plans in such times, but for others, changes in currency, valuation, credit and uncertainty are shorter-term phenomenon that will not change their commitment to continued globalisation. Those that understand the legal risk environment in target counties will be better able to control their overall risk and take advantage of important opportunities in difficult as well as prosperous economic times.

Taking the United States as an example, what do Indian companies need to consider in limiting their legal risk and maximising their opportunities? Among ways to limit legal risk in the US environment, asset and not stock acquisitions can offer valuable risk-control opportunities, and opportunities through asset purchases from troubled US companies—both in and outside of the US bankruptcy



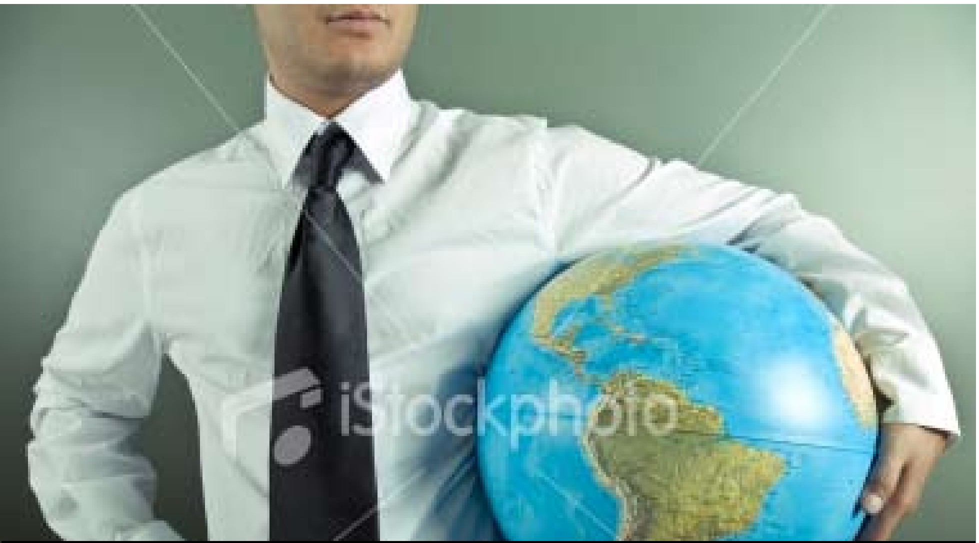
process—offers corporate India an increasingly attractive option.

Factors Continuing to Favour Indian Acquisitions and Other Investments in the US

Though the Rupee/Dollar exchange rate may be less favourable to Indian buyers, what factors beyond the depressed valuations of US companies should continue to capture the interest of Indian investors in US companies?

For example, private equity firms that depend on aggressive debt leverage may be less able to buy into US companies, giving corporate strategic investors from India and elsewhere an advantage. Also, reduced debt leverage in acquisitions also favours smaller acquisitions, and US-bound Indian companies have been favouring smaller deals.[iii] In addition, minority or majority investments by Indian companies that do not insist on a 100 percent equity stake can lead to a hedged risk and take advantage of the experience of existing US management teams (and partnering with US private equity firms can bring capital as well as important US operating experience).

Many US companies are increasingly aware of the potential for India-related value creation through lower-cost back-office functions, software production, other IT services and manufacturing (of particular interest in Chicago and other parts of the US Midwest), and Indian companies have been very interested in accessing US customers and US company marketing capabilities. While some Indian companies believe there may be US political or company cultural concerns over their US investments, we believe that Indian buyers are being viewed very favourably. Beyond the ease of communication between Indian and US executives, our commonalities as citizens of two of the world's great democracies and parallels in our legal systems (fostering, for example, growing legal process outsourcing ties between the US and India), many in the US see great potential in being part of the Indian growth story and are increasingly aware of the tendency of many Indian companies to retain existing management. These factors are sure signs of the increasing integration of the US and Indian economies and the contribution of foreign direct investment to globalisation.



"Many in the US see great potential in being part of the Indian growth story"

Limiting US Legal Risk—Focus on Acquisitions

Unlike in India, China and many other developing economies, the US does not have a general foreign investment notification and approval system that applies to acquisitions and other forms of equity investment. There are still restrictions that may apply in the US, but these are less common for acquisitions of private companies that are not engaged in defense or national security related activities.

Despite the openness in the US to foreign investment and the general opportunities available to Indian companies, the US environment may carry greater legal risk than may be present in India. Hence the emphasis in the US on investment due diligence and creating sensible agreement structures, to help to minimise legal risk. This often results in a longer and more expensive due diligence, negotiation, documentation and closing process for equity investments than is found in India, and our experience has shown that Indian companies can be surprised at the level of costs for US lawyers and other professionals. For example, US law includes very few statutory implied terms and the acquisition agreement serves as a mini code of law. Unless purchaser rights are specified, few will exist—this is why a short and simple agreement, while less expensive and time-consuming, will generally favour the seller.

What are examples of legal risk areas? Even if the target company has no pending litigation, the hidden or unidentified danger of litigation and other liabilities could be greater than the net worth of the target company. Substantial damages, including punitive or consequential damages, are a risk for alleged employee age, race or sex discrimination or personal injuries and commercial damages resulting from allegedly defective products. Other risks can include hidden liabilities, such as payables that were not disclosed, though such issues are not particular to the US.

Note that even a full due diligence review by an acquiring company is not a substitute for adequate representations and warranties, as well as a legal opinion issued by the seller's legal counsel. Other steps to limit risk in an investment deal include: (1) seller representations that no claims exist for specified risks, or that claims will not exceed some specified aggregate amount, (2) seller escrows of a portion of the purchase price for some period of time, with the release of escrow amounts to the buyer if undisclosed or misrepresented problems arise, (3) seller personal or bank guarantees, and (4) insurance to cover undisclosed claims.

US sellers typically prefer stock deals while buyers are generally encouraged to structure transactions as asset acquisitions. Especially when pursuing a distressed target with uncertain liabilities, asset purchases may be the only realistic choice for

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an Indian buyer, and Indian buyers accustomed to stock purchases in domestic Indian transactions (in part since stamp duties imposed in Indian asset purchase transactions are still relatively high) should consider asset purchases in the US.

A purchaser of stock assumes its share of liabilities of the target company—the company's liabilities will follow the new owner, including employee benefits, tax, environmental and product warranties. An asset purchase, on the other hand, can target only selected key equipment, intellectual property, real estate, etc. (other liabilities will remain in the target company), though note that an asset purchase may require more detail and expense and not all assets can be automatically transferred and may require third-party approvals.[iv]

Asset Sale Opportunities in Troubled Economic Times: Acquiring US Companies under US Bankruptcy Laws

Given the current state of the US economy, an increasing number of foreign companies see very good opportunities in purchasing the assets of troubled US companies. The purchase of a troubled company is more complicated than the stock or asset purchase of a healthy US company, though well-advised Indian companies are increasingly able to manage the alternatives available under US bankruptcy law.

As background, U.S. bankruptcy law, commonly referred to as the US Bankruptcy Code, is a national law that applies throughout the fifty US states, though individual U.S. state laws (such as Illinois law for bankruptcy filings in Chicago) supplement this federal law such as in determining property rights. Bankruptcy cases are filed in United States Bankruptcy Court units of the United States District Courts (which are US federal trial courts) located throughout the country (including in Chicago)—bankruptcy cases cannot be filed in state courts. The Bankruptcy Code contains nine separate parts, or chapters, including Chapter 7 governing liquidations and Chapter 11 governing reorganisations.

A. What about an asset sale outside of bankruptcy process—better to buy before a bankruptcy filing?: A conventional asset sale pursuant to an asset purchase agreement may be possible if the target company has not yet filed for bankruptcy. However, while such a sale avoids the expense and procedural requirements of a bankruptcy sale, shareholders and creditors of the selling company may later seek to reverse the sale by claiming that the sale was a fraudulent transfer. For example, the US Bankruptcy Code permits the reversal of a sale as a fraudulent transfer, if the company receives less than reasonably equivalent value for its sold assets and the company was insolvent at the time of the sale.

B. A bankruptcy sale under section

363—real value for foreign buyers: This section of the US Bankruptcy Code allows a purchase of the assets of a company free and clear of liens and claims. This sale process under Chapter 11 of the US Bankruptcy Code involves an offer from an acquiring company (referred to as a "stalking horse") to purchase the assets of the bankrupt company. The bankrupt company is then required to solicit competing bids and to conduct an auction to determine the highest and best bid. Even if the "stalking horse" loses the bid, it can be entitled to compensation for its time and expenses through a break-up fee and/or expense reimbursement that is approved in advance by the bankruptcy court.

- Advantages to the first bidder (the "stalking horse"): If other competing bids can beat the initial bidder as the "stalking horse", why not wait for someone else to act as the stalking horse if you may lose the bid even if you gain a break-up fee? The stalking horse has some real advantages: (1) it is able to negotiate its own deal terms—other prospective purchasers must accept the stalking horse's asset purchase agreement terms with few changes, (2) it is able to perform greater due diligence than a latecomer, and (3) other prospective purchasers must make bids that exceed the stalking horse's bid by at least a specified minimum amount, plus the amount of any break-up fee.

- A deal cleansed of liabilities: The end result, unlike in a conventional asset purchase sale mentioned above, is that the terms of the Section 363 sale are approved by the bankruptcy court and offer the buyer some degree of certainty that it is getting the kind of assets it wants without the kind of liabilities it seeks to avoid. Though Indian and other buyers may be underestimating the legal risks of US acquisitions, here is a way to gain great value and limit such risks.
- Asset agreement and diligence process is otherwise similar: Though the asset sale agreement is subject to bankruptcy court approval, the process of negotiating and documenting the asset purchase agreement and performing due diligence is similar to that of a conventional asset purchase sale.

C. Other options are also open to a company acquiring the assets of a troubled company, including the following:

- Sale under a Chapter 11 plan: This avoids the competitive bidding process under Section 363 and requires the investor to co-sponsor the target's Chapter 11 plan of reorganisation. The Chapter 11 plan is then voted on by the target's creditors.
- Secured creditor foreclosure/sale of assets: Such an arrangement takes the form of a negotiated package with a secured creditor, whereby the creditor would foreclose on a loan to obtain the assets and at the same time sell the assets to a foreign buyer.
- Acquisition of debt or extension of loan: A foreign investor could either extend a loan to a target company or acquire the debt of a target company, and then either exert some degree of control over the target through loan covenants or even exchange the debt for the target's equity.

Indian outbound foreign direct investment may not continue at a record-setting pace in the near term, though Indian companies that recognise that opportunities can be the greatest during periods of uncertainty and pessimism are helping to write a new chapter on India's path to globalisation.

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i) *Grant Thornton, Dealtracker, Third Annual Issue, 2007*

ii) *Grant Thornton, Dealtracker, December, 2008*

iii) *Some 76 percent of 2007 US-bound acquisitions from India were for under US$25 million. Virtus Global Partners, U.S.-Bound Acquisitions by Indian Companies, March, 2008.*

iv) *Asset purchases can also have US tax advantages for an Indian buyer since the buyer is entitled to a "step-up" in the tax basis of the assets being purchased—a later gain would be measured against the value of the assets as purchased. In a stock purchase, the buyer may inherit the basis of the selling shareholders, essentially "stepping into the shoes" of the selling shareholders who may have a basis much lower than the value of the stock as purchased and subjecting the buyer to a later tax on a substantial built-in gain.*

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