Deferment of Consideration and Escrow Mechanism: Analysis

Make in India campaign has triggered progressive changes in policies to foster ease of doing business in India and rationalization of the existing foreign exchange regime. In continuation thereof, the Reserve Bank of India (RBI) had in May this year made an amendment to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 to introduce Regulation 10A with a view to relax the restrictions imposed on the deferment of purchase consideration and escrow mechanism in cross-border share purchase transactions.

The extract of the said Regulation 10A is reproduced hereunder.

The newly inserted Regulation 10A states that:

"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."

Implications of the amendment

Prior to the said amendment, any transfer of shares or convertible debentures from resident to non resident by way of sale required prior approval of RBI in cases where the non resident purchaser proposed deferment of payment of the amount of consideration. Further, the escrow arrangement for payment of purchase consideration was permitted only up to a period of six months from the date of the opening of the account.

The amendment has allowed payment of upto 25% (twenty five percent) of the total consideration on a "deferred basis" within a period not exceeding 18 (eighteen) months from the date of the transfer agreement. An escrow arrangement may be manifested for the deferment of the amount of consideration, provided: (a) the escrow amount shall not exceed 25% (twenty five percent) of the total consideration, and (b) the duration of such escrow account shall not been more than 18 (eighteen) months from the date of the transfer agreement.

It is pertinent to mention that the said period of 18 (eighteen) months commences from the date of the transfer agreement i.e the date of execution of the transfer/ share purchase agreement and not from the closing date i.e. the date on which all the condition precedents to the transaction are satisfied, the seller transfers the shares to the buyer and the buyer pays the consideration to the seller. Invariably in all share purchase transaction there is a gap between the date of execution of the transfer agreement and the closing date. The span of such gap may vary from transaction to transaction having regard to the complexity of the transaction and the extent of the approvals or permissions required to give effect to such transaction. Thus, effectively the deferred period for payment of amount of consideration and the operation of the escrow arrangement is shorter.

The amendment further provides that if the total consideration is paid to the seller, the seller may furnish an indemnity to the buyer for an amount not more than 25% (twenty five percent) of the total consideration for a maximum period of 18 (eighteen) months from the date of the payment of the full consideration.

The deferred payment and indemnity are very popular commercial transaction mechanics, worldwide. As such they play an important role in closing of the transactions, especially in the current economic environment where the buyers are very cautious and intends to mitigate every possible risk attached with a transaction. The deferred payment mechanism facilitates the post-closing price adjustments, which in general means that the buyer will pay part of the consideration to the seller only if the business meets certain performance targets such as revenue and gross profit targets. Pursuant to the above amendment, such price adjustment may be possible within prescribed limits and, thus, would present a win-win situation for both the parties.

Further, any share purchase transaction is based on the representation and warranties made by the seller. If the representation and warranties turn out to be false or incorrect, the seller shall indemnify the buyer for the breach of such representation and warranties. The above amendment gives teeth to the seller's obligation to indemnify the buyer for such breach, where the full consideration has been paid by the buyer to the seller.

Conclusion

The amendment creates a positive impact in facilitating ease of doing business in India, mitigating risks and protecting the investor's interests. Escrow mechanism and indemnity are significant components of mergers and acquisitions. Deferred payment of consideration increases flexibility and is favourable to the transacting parties. India is emerging as a preferred destination for doing business and the RBI is creating a regulatory regime that gives further impetus to bilateral transactions in tandem with the economic growth. The amendments are likely to ensure protection of the parties' rights and expedite cross border transactional movements.