



## THE GLOBALIZATION OF THE INDIAN STARTUP SPACE: OPPORTUNITIES AND CHALLENGES

*By Anirudh Suri*

**I**n the first week of July 2014, a group of Indian investors, on a trip to Sri Lanka, listened to several startup pitches by Sri Lankan entrepreneurs. From this experience, three key insights emerged: one, the proposed startup ideas were very basic in their nature (e.g., a proposal to found an e-commerce platform); two, the growth projections were very small, as a result of the small consumer and business-to-business (“B2B”) market that exists in Sri Lanka, especially in comparison to India’s markets; and three, the entrepreneurs did not seem very ambitious or for that matter, driven to build large, profitable businesses.

One can argue that U.S.-based venture capitalists (“VCs”) have historically chosen not to pay much attention to Indian startups for all the same reasons. While these opinions might have been an accurate assessment a few years ago, the time has come for U.S. VCs to start paying attention to the Indian startup ecosystem.

*continued on [page 6](#)*

***This Issue's Special  
Focus:  
VENTURE  
CAPITAL***

**The ABA Section of  
International Law Names  
India Law News  
Outstanding Committee  
Newsletter of 2014**

## GUEST EDITOR'S COLUMN

A stable government and renewed focus on pushing through economic and legislative reforms has brought India back on the radar of foreign investors. The U.S. - India relationship has received a shot in the arm after the recent visit to the U.S. by the Indian Prime Minister, Narendra Modi. At the same time, this year has witnessed increased interest and active venture capital investment in early stage companies, particularly in the internet and mobile space in India. Global venture capital investments in Indian startups have been accompanied by rising instances of Indian entrepreneurs looking to enter the U.S. market.

Amidst such positive macro-trends, the India Committee is pleased to present the timely theme of "Venture Capital in U.S. and India: Key Considerations" for the latest edition of India Law News.

This edition is a follow-up on the teleconference organized by the India Committee on this topic. We have been fortunate that some of the best minds engaged with this space in India—entrepreneurs, fund managers, and lawyers—have contributed to this issue.

Anirudh Suri, Founding Partner of the India Internet Group, and an entrepreneur discusses the globalization of the Indian startup space and provides an interesting perspective on the opportunities and challenges emerging in the space. Cyril Shroff and Ravi Kumar outline the challenges that persist in venture capital investments in India. While Christopher McHattie, Neeraj Joshi and Jack Baldini discuss critical issues of intellectual property and innovation. Abhijeet Sonawane and Bhanudey Singh Kanwar discuss venture capital and leveraged buy-outs in India. Last, Mukesh Butani, Sumit Singhania and Rahul Yadav discuss the Indian Budget of 2014 and the constitutionality of retrospective legislation. It pleases me that the India Committee has broadened its audience to include not just the U.S. and Indian legal fraternities but also U.S. and Indian VCs and entrepreneurs. Together, our contributors paint a detailed picture of the existing landscape, and the opportunities these recent developments provide for lawyers, investors and entrepreneurs interested in India.

I have had the privilege of guest editing this issue, and it would not have been possible without the able assistance of our India Law News editorial team. We hope you all find the issue useful and insightful. Best wishes for a happy and healthy 2015 to all our readers.

### Shikhil Suri

*Guest Editor, Summer/Fall Issue 2014*

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## CONTENTS

### OVERVIEW

- 2 *Guest Editor's Column*
- 4 *Co-Chairs' Column*



### COMMITTEE NEWS

- 30 *Submission Requests*
- 31 *Join the India Committee*



### SPECIAL FOCUS

- 1 *The Globalization of The Indian Startup Space: Opportunities And Challenges*
- 10 *Venture Capital Investments in India: Issues And Challenges*
- 16 *Raising Venture Capital In The United States: Intellectual Property Protection Is The Key*
- 20 *Venture Capital And Leveraged Buy-Outs In India - The Road Ahead*
- 23 *India's Budget 2014: Whither Amendments to Tax Laws Applied Retroactively?*



### CASE NOTES

- 29 *India Law News Receives The Award For Outstanding Committee Newsletter Of 2014*

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The summer has ended and the India Committee has transitioned to its new 2014-2015 leadership team. We are all rolling up our sleeves and eager to get to work on what we hope will be an interesting and exciting year for the Committee and the Section of International Law.

First, we want to thank Sanjay Tailor for his outstanding work as the lead Co-chair of the Committee last year. He was tireless in his efforts, outstanding in his insights, and a most effective leader. Happily, Sanjay is not lost to us as he continues to be active in the Committee and its activities for which we are very thankful.

We also have to thank Bhali Rikhye and the India Law News team for their extraordinary effort in producing the India Law News. We are happy to report that these extraordinary efforts have been well recognized as the India Law News has received accolades from the Section of International Law for the newsletter's quality as a Committee newsletter. The India Law News is now the recipient of the Section of International Law's Outstanding Committee Newsletter Award. Producing the India Law News is a very time-consuming task and requires considerable effort, ingenuity, and dedication from a number of people who give very freely of their time and their knowledge. We are most thankful to Bhali and his colleagues. We also need to thank Poorvi Chothani and her office for all their hard work in formatting the materials that comprise the India Law News and putting them in an appropriate form for publication.

In the coming year, the Committee will be enhancing its website and its blog. Stay tuned for more information about these activities. As many of you know, while the articles that appear in the India Law News are in electronic form, it is almost impossible to find on the web or to search them on the web. The Committee is about to change that by putting all past articles and all future articles directly on the web in searchable form. This is a very significant undertaking, and it will involve considerable effort, much of it provided on a voluntary basis at no or limited cost to the Committee. The practical result of all of these efforts will be to put the entire content of India Law News on the web in searchable form, which will make that information significantly more valuable as people come to rely upon it as a valuable resource for knowledge and information about Indian law, once they realize how easy it is to find that information.

While it is still early days, the Committee is planning some significant programming for presentation as panels at the Section of International Law Spring Meeting. In addition, the Committee is planning to sponsor a delegation from India that will follow the Spring Meeting. There will be more about this as things progress.



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### SUBMISSION DEADLINES

|              |              |
|--------------|--------------|
| Fall Issue   | August 1st   |
| Winter Issue | November 1st |
| Spring Issue | February 1st |
| Summer Issue | May 1st      |

Potential authors should review the [Author Guidelines](#) and send manuscripts via email to the [Editorial Board](#).

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One very important aspect of Committee life is the monthly "Committee Conference Call," which normally takes place on the first Tuesday of every month and lasts not more than an hour. The timing for the call is such that it occurs early in the day on the East Coast of the United States, and early in the evening of that same day in India. This call is open to every member of the Committee and we would strongly urge active participation. This is one of the best ways to get to know other members of the Committee and to learn about and influence the Committee's plans and activities.

On the political side, the Committee was very pleased to see a thawing of relations between the United States and India with the meeting of the U.S. president and the Indian Prime Minister in Washington, D.C., while the Prime Minister was in the U.S. to attend the United Nations' meetings last month. One of the Committee's primary efforts is to build and enhance bridges between the United States and India. Hopefully, we will be entering upon a new era in bilateral relations between the U.S. and India that will offer even better opportunities to pursue this important mission.

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**Shikhil Suri**



## THE GLOBALIZATION OF THE INDIAN STARTUP SPACE: OPPORTUNITIES AND CHALLENGES

*By AnirudhSuri*

*continued from [page 1](#)*

In this article, I outline recent development in the Indian startup ecosystem, why it is imperative for U.S. VCs and lawyers to engage with the ecosystem, and what role they can play. I conclude by outlining some risks and inimical factors that remain potential hindrances to the uninterrupted growth of this ecosystem.

### Recent Developments in the Indian Startup Ecosystem

There are at least five significant recent developments in Indian markets that bear noting by U.S. VCs and lawyers. The first is that the Indian mobile phone and internet market is fast catching up with the U.S. The number of internet users (and even mobile internet users) will surpass the U.S. market in a matter of years. While the monetary value of transactions will probably still remain lower than in the U.S., the number of transactions will reach a comparable number. With over 150 million smartphones, almost 200 million internet users, a fast-evolving mobile application ecosystem, improving infrastructure, and, hopefully, the introduction of 4G later this year, the Indian market is now going through its inflection point.

Second, startup ideas are no longer too simple. About three years ago, Indian entrepreneurs were still coming up with very basic ideas (e.g., listing sites, e-commerce sites, restaurant discount sites). Not surprisingly, one could argue that the Internet market had not developed much because Indian e-commerce sites like “Flipkart” or “Snapdeal” had not yet become household names.

Today, however, the situation is different. Let us take a few examples. Tookitaki, a portfolio company of India Internet Group has built a sophisticated audience targeting and re-targeting platform that is being used by advertisers in India, Singapore and Australia. Another, AdNear, a location-based advertising technology platform funded by Sequoia, Canaan and others, today serves customers across India, Australia, New Zealand, the U.S., and South East Asia. Lastly, Zomato, starting out from Delhi as a menu-listing platform, has evolved into a strong global player, becoming the leading “Yelp”-like product for over 15 countries across the world, including the U.K., U.A.E., and Chile. And the success stories do not end there. Startups such as Findable.in, a location-based product search and local delivery platform (another IIG portfolio company), and Capillary (Sequoia, Norwest and Amex-funded), a retail CRM platform, are at the forefront of innovating and building products that aim to solve global problems.

The third important development is that technological entrepreneurship has really spread its roots in India over the last few years. The Indian startup ecosystem has evolved rapidly and it now encompasses startup weekends, hackathons, startup pitches, a multitude of angel investors, institutional venture capital at all stages, mentors, potential acquirers, and support service providers. Of course, there is a long way still to go, but the roots of this tree have really gripped the ground. India is increasingly seeing entrepreneurs who have the ambition, the drive and the ability to take the global market by storm. The high quality of Indian entrepreneurs is being supplemented by an increasing amount of exposure to

the way big companies have been built in the U.S. and elsewhere.

Fourth, Indian startups are continuing to derive the benefits of inexpensive, quality product development and engineering talent within India but targeting the global market and expanding rapidly. Many new Indian entrepreneurs are building products for the U.S. market—both on the consumer and B2B side. Admittedly, it might take a little bit more time before Indian products succeed in the U.S. consumer internet space, but not so in the enterprise space. Examples such as Capillary, InMobi, and others come to mind as companies already demonstrating success in the U.S. enterprise space.

Other Indian entrepreneurs, who have tasted success in the domestic Indian market, have ventured abroad in an eastward direction—entering Southeast Asia, Indonesia, and Australia. It is more likely that Indian consumer web startups will taste success earlier in South Asia and Southeast Asia than the U.S. or Europe, since the internet consumer and the market dynamics in Southeast Asia and South Asia are similar to the consumer and market conditions in India.

Finally, India is now starting to import back engineering and product talent that it had been exporting for so many years. Several Indians, who have worked and scripted great growth stories for U.S.-based startups, are now turning their eye back to India. Armed with very valuable product management and/or engineering experience, these U.S. employees-turned-entrepreneurs in India, are a great addition to the Indian startup space that had previously lacked real product experience.

These developments have immense implications not just for the U.S. and India, but also potentially for the rest of the world. The Indian product startup story today is analogous to where the Indian IT outsourcing industry, which has gained global prominence in the last two decades, was in the 1980s. While enterprise product plays will target the U.S. and other developed markets, Indian consumer web/mobile plays will likely

target Southeast Asia, Middle East and gradually Africa, similar to how Indian CPG (Consumer Packaged Goods)/FMCG (Fast-Moving Consumer Goods) companies have expanded to these regions that display characteristics similar to India. Although nascent, the macro trends outlined above clearly point to India becoming an important source of tech product innovation for the world in the coming decades.

This is the primary reason why it is important for U.S. VCs and lawyers—who have traditionally been at the forefront of both encouraging innovation and defending intellectual property rights—to become closely engaged with the Indian startup space and help bring global best practices into these spaces.

### **Role of U.S. VCs and Lawyers And Opportunities for Engagement**

What can and should U.S. VCs and lawyers be doing to engage with the Indian ecosystem? One, start working with early stage startups and venture capitalists so they begin adopting the best-in-class fundraising and legal practices early on. A simple example would be adherence to intellectual property laws, which startups often remain ignorant of or willfully ignore only to rue it later. It is these early stage startups of today that will become the Flipkarts and Snapdeals in a few years, so lawyers would benefit from working with these companies from their early days. The companies would benefit because they could then avoid the kind of massive penalties that Flipkart was recently slapped with.

Second, the legal community could play a very important role by helping shape regulations as they evolve in India. Prominent law firms and lawyers can help policy makers understand the nuances and legal implications of the policies that impact the internet sector. For example, mobile payments as a sector has not grown rapidly largely due to its heavily regulated nature. Legal practitioners can play an important role by helping the Reserve Bank of India come up with more startup-friendly policies that allow for innovation in this space.

Third, many Indian startups are today raising capital not just from Indian sources but also abroad, especially when they are targeting the global market. U.S. venture capitalists and lawyers can be very helpful in this process, as most Indian startups do not know how to structure their fund raising process or even creation of U.S. entities (let alone flipping the company to be incorporated in Delaware etc.).

Fourth, large Indian startups are also now on the prowl for potential acquisition opportunities not just within but also outside of India, leading to several cross-border deals that lawyers can help structure. For example, Myntra.com (one of India's leading fashion e-retailers) acquired a San Francisco based startup, Fitiqutte. India's homegrown Yelp, Zomato.com, acquired a company in New Zealand and two companies in Eastern Europe (Lunchtime and Obedovat) in recent months in its quest to go global, very fast. Zomato, already one of the world's largest restaurant discovery services, is present in 15 countries.

The reverse is also true. Many U.S. and other global technology companies are now starting to actively look at Indian startups for potential acquisitions—examples include the recent acquisition of Little Eye Labs by Facebook or RedBusby Naspers. Cross-border deals will only increase in volume and size over the near short term.

### **Risks and Hindrances Remain**

Of course, the picture of the Indian startup ecosystem is not completely rosy. Several factors remain inimical to the interests of the Indian entrepreneurial ecosystem. However, the existence of these factors makes the more active engagement of the best-in-class financiers, lawyers, product managers, engineers and marketers even more necessary to nurture and guide the Indian startup space along.

First, while the talent at the top is great, the middle and lower tier of talent in Indian startups is still subpar compared to the U.S. Hiring and retaining talent remains a massive hurdle in the ability of startups to

both take off and scale up. This obstacle is a manifestation of the larger problem in India of unemployable graduates and also a general lack of understanding of the way entrepreneurial activity can really pay off in the long run. There continues to be an over-emphasis on the "highest salary package" and not enough emphasis on co-ownership of the company through equity and Employee Stock Options.

Second, VCs in India by and large still remain risk-averse to innovative products and new business models, preferring instead to back tried-and-tested formulas, especially in the consumer web space. Furthermore, this risk-averse behavior is generally pervasive in the early stages of the investment cycle as well, which hurts the ability of entrepreneurs to experiment.

Third, regulation and compliance-related issues often tend to slow Indian startups. While this has been the case for larger Indian businesses for years, the Indian government in recent years has started to regulate the internet space, and also related sectors such as Foreign Direct Investment in e-commerce. If Indian investors do not have financial pockets deep enough for a Flipkart to compete with Amazon, then how can the government expect more home-grown large businesses to launch and also succeed in the long run?

Fourth, infrastructure issues still hamper the growth of Indian's internet/ mobile market. Despite the launch of 3G (and the impending launch of 4G) and cheaper mobile phones; internet speeds and penetration still have a lot of room to grow. Key elements such as effective mobile payments systems have not been completely cracked yet and a litany of other infrastructural deficits remain.

The good news is that none of these issues are hidden or unknown to the leaders of the internet/ mobile market in India. As a result, industry bodies such as NASSCOM (The National Association of Software and Services Companies) or the Indian Angel

Network, as well as prominent firms and individuals continue to work hard to reverse these inimical factors.

As India grapples with the opportunities and challenges that the rapid emergence of the internet and mobile internet has thrown up, greater engagement with U.S. investors, lawyers, and others would not only help accelerate the growth, but also prevent missteps. The Indian internet market is at a point where these stakeholders can create great value for themselves, and for the global ecosystem, by first understanding and then tapping the immense potential that remains to be unlocked.

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## VENTURE CAPITAL INVESTMENTS IN INDIA: ISSUES AND CHALLENGES

*By Cyril Shroff and Ravi Kumar*

### I. Introduction

The volume of venture capital investments in India has been increasing steadily. According to the *Economic Times* (July 2, 2014), the 121 investment deals in early-stage companies and start-ups in the first half of 2014 constituted a 40% increase in the number of such deals compared with the same period in 2013. The transaction value of these 121 deals was \$605 million (₹ 36.3 billion)—a 66% increase from the same period in the previous year. This surge in early-stage investments has been led by an increased appetite for investments by venture capitalists (“VCs”) in consumer technology (with e-commerce being by far the favorite), healthcare, technology and education. The strong appetite for investing in VCs has been hard to satisfy—and competition among VCs for investment opportunities remains high—in part because of a paucity of good-quality deals. This has caused VCs to take more time to become comfortable with value creation potential and conduct more comprehensive due diligence than before.

The goal of this article is to provide a brief overview of some of the legal and regulatory challenges that currently face VCs in India as they invest in Indian portfolio companies. The article will describe the various stages of the investment process and the key challenges VCs encounter when investing in India.

### II. Entry and the Investment Phase

#### A. Regulatory Valuation Requirements

India does not have full capital account convertibility. Instead, the Indian government imposes extensive foreign exchange control regulations. These include restrictions on pricing for the issue of shares

(including compulsorily convertible preference shares or debentures) by Indian companies to non-residents and transfers of shares between Indian residents and non-residents. Both the issue of shares and the transfer of shares between residents and non-residents, or vice versa, are subject to a floor price, or cap (depending on the counterparties) at the fair value of the shares, determined in accordance with internationally accepted valuation methods certified by a chartered or certified public accountant or a registered merchant banker. These valuation requirements are prescriptive and the valuation certified by such a valuer is typically not examined in detail by the regulators. While these measures are intended to ensure that transactions with non-residents and Indian parties take place at a fair value, the requirements can become contentious, especially at the time of exits.

The Companies Act, 2013 (the “Act”) includes a similar provision, which subjects any preferential allotment by an Indian company to a floor valuation certified by a registered valuer. While these provisions of the Act are not yet in force, the valuation should be certified by a chartered accountant with at least ten years of experience or by a registered merchant banker.

#### B. Running the Preferential Allotment Process

Currently, company law in India is undergoing a complete change following the enactment of the Companies Act, 2013, which replaces the earlier Companies Act, 1956. The 2013 Act imposes additional requirements for allocating a preferential allotment to a non-resident. This requirement is a clear departure from the earlier regime. Under the Act, Indian companies can make a preferential allotment only after obtaining the approval of 75% of the shareholders present and voting at a shareholder meeting. The Act requires that an offer document that needs to conform

to a prescribed format has to be issued to the allottees. This document forms the basis for the allotment and can be issued to the allottee only after the passage of the shareholders' resolution mentioned above. This requirement is a complete departure from the earlier regime because: (1) the basis for the allotment was the contractual agreements between the company and the investor; and (2) private companies did not require approval of the shareholders for preferential allotment; approval of the board of directors was sufficient. As a result, coordinating executions becomes more challenging with these additional requirements because the corporate approvals from the investee company must be obtained prior to the execution of the definitive documents and there is additional paperwork (i.e., the offer document). In a private company, planned coordination can ensure that all of these actions take place sequentially on the date of execution itself, thereby placing increased emphasis on planning out the closing date actions. The coordination required by these new procedures makes the execution process cumbersome.

Given certain ambiguity in the purpose or intent of relevant provisions of the Act, considerable debate exists regarding whether these provisions apply to negotiated investment transactions (such as bilateral investments or co-investments) or whether they apply to preferential allotments made to multiple unrelated parties (i.e. non co-investments).

### C. Finalizing the Capital Structure

For obvious reasons, finalizing the capital structure is another critical aspect of pre-investment. Capital structure changes are attributable to two factors: (i) investment in compulsorily convertible preference shares by the VCs and (ii) employee stock options ("ESOPs") issued by the target company. While both these situations are well documented, the consequent impact needs to be factored in and handled carefully while finalizing fully diluted ownership of the VCs. While VCs recognize the importance of ESOPs for attracting competitive talent at lower salaries, VCs are reluctant to dilute their equity stake. Consequently,

pre-investment discussions on the size of the ESOP pool tend to be long-drawn. The situation gets exacerbated from the portfolio company's perspective as the vintage of the portfolio company increases because the pool typically reduces on a yearly basis as new ESOPs vest.

The outlook on the ESOPs and the VCs' requirement to maintain shareholding may be at cross-purposes requiring careful handling, particularly when a VC exits. Consequently, VCs prefer ESOPs which do not result in accelerated vesting at the time of an exit or sale of the portfolio companies. As a result, ESOPs achieve the objective of compensation and with these clauses, the VCs' stake does not get diluted upon an exit. However, these discussions tend to be difficult, nuanced, and emotive because the promoters (and the employees) of the portfolio company would like to cash out in a sale transaction at the least. With increasing awareness among employees of this issue, such an approach may be difficult to follow because the employees are likely to demand ESOPs with accelerated vesting at the time of a VC's exit or a sale transaction (at the very least).

### D. Voting Rights

Another fairly common problem regarding the capital structure is linked to voting rights on shares. The Act prohibits holders of compulsorily convertible preference shares from exercising voting rights on these preference shares unless such matters directly affect the rights of the preference shareholders. This prohibition marks a departure from the earlier version of the Act that permitted these arrangements in the context of private companies. Of course, if the company does not pay a preferred dividend on the preference shares for a period of two years or more, then the preference shares will be entitled to voting rights on all matters being decided at a shareholder meeting.

### E. Non-compete restrictions on Promoters

Typically, investment transactions impose strict non-compete and non-solicit obligations on the

promoters (i.e. controlling shareholders). Given that VCs will be making investments based on the commitment of the promoter(s) to the target company, the VCs would naturally want the exclusive, ongoing focus of the promoters to be the business of the company. India's cultural and traditional background of extended families and relations encourages these obligations to be broad and wide (i.e. direct and indirect obligations of the promoters). However, enforcement of these obligations in "indirect" situations, such as, businesses promoted by relatives, remains a massive challenge given the difficulty of proving "indirect" competition by Indian promoters. Consequently, the legal challenge consists of articulating these obligations in broad terms to cover indirect competition and taking adequate steps, which impose strong disincentives for breaches, to ensure that the promoters comply with their obligations.

#### F. Director Liability

Indian law has always recognized the fiduciary duty owed by the directors to a company. However, the Act has changed the role and responsibility of directors by encouraging their active participation in the company's affairs and increasing director liability aimed at curbing instances of corporate malpractice in India, such as falsification or manipulation of accounts by promoters and diversion of funds. The Act has extended the fiduciary duty concept and codified the directors' duty to act in the best interests of not only the company and its shareholders, but also those of the community at large. Even though this list may appear innocuous, it is sweeping and encompasses a diverse set of interests, which the directors may find difficult to balance. Further, there is insufficient guidance on how a director is expected to discharge these duties. This increase in the duties and liabilities of the directors is, however, not accompanied by a concomitant enhancement of incentives to act as a director, thereby igniting a lively debate. Moreover, while the enhanced penalties provided by the act could motivate directors to participate more actively in a company's affairs, the specter of personal liability can effectively discourage

VCs from nominating directors on the board of directors of portfolio companies.

The Act limits the liability of independent and non-executive directors to (i) those acts and omissions that have occurred with the knowledge of these directors, where such knowledge can be established through evaluation of the processes followed by the board of directors; and (ii) a director's consent or connivance with respect to the proposed corporate action, or failure to act diligently. The Act continues to recognize the right of the directors to record their dissent, which should be diligently recorded to establish a legal defense for mitigating any potential liability. The Act seems to permit a company from indemnifying its directors from any liability incurred on account of negligence, default, misfeasance, or breach of duty or trust, which is a departure from Act's predecessor. This position seems to be a tacit acknowledgement for permitting directors and officers insurance policies to protect against liability. However, these may not obviate the concerns of VCs when they appoint directors on the board of portfolio companies given reputational and other aspects involved in such sticky situations.

In addition to the increased obligations of directors under the Act, various Indian statutes (such as labor, welfare, and environmental legislation) impose personal liability on directors for infractions by the company. While some of these statutes provide similar exclusions for the liability of directors who can demonstrate that they were not involved in the breaches by the company, the looming threat of director liability creates significant obstacles for institutional VCs, especially given that these investments typically occur in the early stages of investment.

As a fall-out of these positions in Indian law and with a view to managing the risk of liability of nominee directors, there is an increasing trend for foreign investors to seek the right of appointing directors to the board of directors of portfolio companies as well as non-voting observer rights for attending board meetings. In practice, the VCs seem increasingly

content to allow their representatives to attend board meetings as observers and not exercise their rights to appoint nominees on the board of directors.

### G. Veto Rights and Control

One of the most critical ways VCs protect their rights is through their ability to veto decisions undertaken by their portfolio companies. The justification for these veto rights is investor protection, i.e., the ability of VCs to determine whether portfolio companies may undertake certain actions that would have an impact on the value of the company. Unlike growth capital or late stage investors, VCs typically obtain veto rights on a few significant items, such as changes in capital structure, approval of the business plan or budget, and appointment or replacement of key managerial personnel.

Section 2(27) of the Act defines “control” inclusively as the right to, directly or indirectly, “control the management or policy decisions” exercisable by a person, either individually or in concert with the other persons, by virtue of shareholding, management rights or shareholders’ agreements, voting arrangements, or in any other manner. The Act imports this definition verbatim from the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (the “Takeover Code”), although the context is arguably different. Under the Takeover Code that is applicable to Indian listed companies (i.e., whose equity shares are listed), a change in control triggers an open offer to the shareholders to acquire at least 26% of the target company. Under the Act, acquiring “control” could make such a person a “promoter” (another new concept under the Act), the identities of whom must be disclosed annually in filings submitted to India’s Ministry of Corporate Affairs.

The Takeover Code constructs veto rights and control to mean that any investor with these rights acquires control. If the same interpretation is adopted, VCs who acquire such veto rights would be adjudged to be in control of the target company, necessitating

their disclosures as “promoters” in India on an annual basis. This could potentially trigger consolidation requirements overseas for VCs. Indian lawyers are still considering this issue, and a final answer remains elusive.

## III. Exit Related Issues

### A. Enforceability of Put and Call Options

The status of put and call options involving residents and non-residents (including VCs) under Indian regulations has been ambiguous for some time. While, under Indian securities law, doubts existed regarding the enforceability of such options on the securities of public companies (including unlisted public companies), the exchange control implications of such arrangements were likewise uncertain. To draw an important distinction, although Indian securities law permitted put and call options for securities of private Indian companies, issues in relation to the pricing of these put and call options remained because of foreign exchange control regulations.

Indian regulators have clarified these positions over the past year. Put and call options on securities of public companies in India are now enforceable subject to a holding period of at least one year, and Indian exchange control regulations currently regulate pricing. Interestingly, these changes are prospective and do not apply to earlier investments.

Indian exchange control regulations prohibit fixed price put and call options on securities of Indian companies. However, the regulations permit put and call options based on fair market value at the time of exit at a price not exceeding the price computed under any internationally accepted pricing methodology. In essence, the regulations prohibit guaranteed or assured exit pricing because the Reserve Bank of India views such options as guarantees back-stopping debt instruments. While this approach may not be a significant departure from the previous one (being that investors must comply with pricing norms at the time of exit following an option exercise), the most

significant question elicited by this change is whether the transaction documents can even set out an internal rate of return based option price.

While some embrace the changes for creating certainty regarding legal enforcement, others bemoan the lack of contractual flexibility to provide exits to investors in a market where exits are growing increasingly tougher.

### B. Buy-back Related Issues

Another typical exit mode for VC investments consists of buying back shares of the portfolio company. Share buybacks in India are heavily regulated and subject to a whole range of restrictions from a cap of number of equity shares that can be brought back (25% of the equity shares) to the quantum of funds that can be utilized for a buy-back (25% of the paid-up share capital and free reserves of the portfolio company) and other considerations that render buying back in India cumbersome and ineffective. An added complication is that Indian regulators view buy-backs as transfers of shares from non-resident to resident Indians and therefore apply the relevant pricing regulations.

### C. Capital Markets Related Issues

Preparing for an initial public offering (“IPO”) in India is a time-consuming and painstaking exercise involving investors, the company, promoters, employees, merchant bankers, and lawyers. In most cases, an IPO takes upwards of seven to eight months from start to finish, assuming steady market conditions (a very big ask indeed). However, other complications have emerged recently. For instance, in the Just Dial IPO the Securities and Exchange Board of India, India’s capital markets regulator insisted on a “safety net” for retail investors, which was price protection for a period of sixty days. Under this requirement, Just Dial had to refund retail investors in case of a price fluctuation after this period. One of the reasons set out for this requirement was that the fact that the company was in a “new sector.” Given these sorts of additional

requirements, capital market backed exits pose their own set of challenges for VCs and the company.

### D. Currency Related Issues

Although not a legal or regulatory issue, the plunging value of the rupee has sucked out the potential profitability that most VCs expected. This inflation has caused many exit deals to fall through because VCs are betting on a rally by the rupee or better performance by the portfolio company.

### Conclusion

Despite the many challenges for VCs, the ecosystem for early stage investments is definitely developing and improving in India. The Act sets out a corporate governance framework applicable to all companies. It is intended to improve governance levels across companies. Such improvements will benefit VCs. The recent election results giving a clear majority to the present government has also provided reassurance in the form of enhanced stability to investors across the spectrum. Analysts generally agree that India’s new government will pass and enforce regulations in a way that is more beneficial to business and investment, with the clear majority also providing enhanced stability that the investment community requires to thrive.

VCs are also sharpening their focus on the best-quality deals based on their investment philosophy and are investing in relationships with promoters and management teams with a view to determining reasonable valuations, growth plans, and exits. In addition, the emphasis on value creation after the acquisition has gained more importance. Moving forward, VCs should focus on the “softer” aspects of the deal, such as corporate governance and the integrity of the leaders of the target company, as much as on issues relating to the valuation itself.

In sum, even though VCs are wisely approaching investing in India with increased caution and clarity, the India story is alive and here to stay because VCs

continue to believe in the long-term potential of India and the value of staying invested.

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## RAISING VENTURE CAPITAL IN THE UNITED STATES: INTELLECTUAL PROPERTY PROTECTION IS THE KEY

*By Christopher J. McHattie, Neeraj R. Joshi and John B. Baldini*

**N**arendra Modi, the newly elected Prime Minister of India, punctuated his first visit to the United States by making a memorable appearance at Madison Square Garden on September 28, 2014. A crowd of 20,000-plus raucous supporters who had traveled worldwide to reach New York City welcomed Mr. Modi and enthusiastically cheered the Prime Minister's bold statements regarding the new direction in which he and his party are going to take India. Mr. Modi commenced his speech with an anecdote which he hoped demonstrated India's transition from a nation of "snake charmers" to a nation sporting expertise with another animal – a "mouse" – as in a computer mouse. Central to Mr. Modi's speech was his outlining of three advantages India has for accelerating its growth: democracy, demographics, and demand. Juxtaposing these three D's with Mr. Modi's self-acknowledged symbolic journey from tea vendor to Prime Minister underscores the new Indian government's emphasis on entrepreneurship and robust technological progress. Judging from the crowd's excitement level, there is reason to hope that India is once again on the move and a country with which America and the world will want to do business.

Even before Modi's U.S. visit there was reason for optimism that the commercial ties between the United States and India will improve. In particular, recent developments and changes in law and commerce have coordinated the two countries' approaches and spurred venture capital funding of startups and the intellectual property ("IP") protections underlying those startups. That funding has come from both government and private sector sources. In turn, that has led to a surge in confidence for innovators, small businesses, government officials and the venture capitalists behind those investments. These developments reflect the fact

that India's entrepreneurs are increasingly turning their attention to setting up technology companies, such as mobile-based software startups. Cloud computing and software in particular has led to a spike in innovation. That spike in innovation has led to a corresponding spike in investment, both private and public. Both countries recognize that the fuel that will continue to drive this investment is technology born of entrepreneurial innovation and good management. They also recognize that the venture capital that underpins entrepreneurial innovation thrives best in an environment that provides solid intellectual property protection.

India's venture capital industry is still nascent compared with the United States and other developed economies. The Indian government's plan to create a ₹100 billion fund to boost India's startup industry promises to change that. The plan has been greeted positively as a boon toward promoting entrepreneurship. While the details of how the plan will work and funds be disbursed have yet to be disclosed, it has the potential to motivate more Indians to consider start-ups to meet market needs, particularly in the technology sector where venture/early stage investment has recently increased significantly.

### **India's "10,000 Startups" Initiative & the MSME Project**

Moreover, India's National Association of Software Companies ("NASSCOM"), the lobby group for India's information technology industry, has funded, accelerated and mentored 150 companies of the 500 shortlisted from a pool of 7,000 applicants. NASSCOM's goal is to encourage 10,000 technology startups in India over the next decade. Impressively, Google, Microsoft, Verisign, and Kotak Mahindra Bank (and others) support the venture. After the March 2013

launch, 332 out of 4,000 applying startup companies were selected to receive a unique chance to meet venture capitalists, investors, and mentors. This 10,000 Startups Initiative is just one example of why knowledge and development of venture capital and technology development is in the forefront of India's emerging economy.

India's Union Ministry for Communications and Information Technology, too, plans to launch a scheme by November 2014 to "provide financial support to Micro, Small and Medium-scale Enterprises (MSMEs) and start-up companies to help them with international patent filing." The ministry plans to encourage patent filing within the next three months, boost innovation and promote opportunities for growth.

Regardless of these new opportunities for Indian entrepreneurial innovators to raise incubator, start up and venture capital in India, the new environment could well see those entrepreneurs also looking for such capital in the United States. For that to happen, it will be critical for Indian entrepreneurs not only to innovate and manage their enterprise successfully, but also to ensure strong worldwide IP protection for their innovations.

### **IP Protection is the Foundation Upon Which Successful Entrepreneurial Innovation is Built**

The common theme in all recent developments in the venture capital sector is the recognition that investment is driven by sustainable business models adequately protected by IP. It cannot be gain said that venture capitalists are not interested in investing in technologies or companies that do not possess a favorable place in the marketplace. This favorable place in the marketplace is created, in part, by an attractive IP portfolio which preserves the right to exclude others from manufacturing, using or selling a technological breakthrough—in short, a monopoly on the "must have" technology or solution.

Oddly, the importance of IP is not often understood. For example, in an article entitled *Want*

*Venture Capital? Here Are 10 Must-Haves*, the magazine *Forbeswoman* advises the would-be entrepreneurial innovator to "1.) Target a large, lucrative market 2.) Address a big market opportunity 3.) Produce a maximum return on investment 4.) [Raise] outside money to scale 5.) Build product traction 6.) Differentiate yourself from your competition 7.) Put together a top-notch team 8.) Be prepared to give up a board seat 9.) Connect personally 10.) Be coachable." What is not mentioned is IP.

Yet, in reality, IP has to be one of the first areas of inquiry. Joseph G. Hadzima, Jr., of the MIT Sloan School of Management recently developed a formula for evaluating a company's patents as a predictor of future success. His company evaluated the patent portfolios of 9,000 venture capital-backed companies. Their "analysis demonstrated that 86% of winners had strong (versus typical) IP portfolios." This finding shows that IP supports are the very foundation of all ten *Must-Haves*.

### **The Critical Role of Due Diligence**

The Indian entrepreneurial innovator looking to raise venture capital in the United States must also conduct due diligence for prospective venture capitalists. For example, in the case of an investment in an online company, any investor would want to confirm traffic flow and the sustainability of that traffic flow. Similarly, an investor considering an investment in a pharmaceutical company would want to confirm efficacy of the existing portfolio and any new ones in the pipeline, and confirm that appropriate patent protection is in place. In such a case, the prospective investor will read, and in some cases even attempt to reproduce, efficacy studies, and call upon patent attorneys to review not only patent applications but the field of the invention generally to ensure: (a) the patent has actually issued, (b) it covers the material composition of the product(s), (c) there is no flaw within the filing history upon which an attack to invalidate the patent might be based, and (d) the patent is not invalid based upon prior existing compositions.

The following is an example of a fairly standard IP Due Diligence inquiry directed to an information technology company operating a series of domains:

### Intellectual Property

1) Documents relating to the Company's IP rights (including patents, trademarks, service marks, trade names, corporate names, copyrights, trade secrets, etc.), and all registrations, applications, royalty agreements and licenses held or granted with respect thereto. In particular:

- (a) Identify all patents and patent applications;
- (b) Identify all trade names under which the Company operates and all trademarks used by the Company for its products and/or services and provide copies of all registrations and applications relating thereto;
- (c) Identify, and provide registrations and agreements relating to, all material copyrightable works created by or for the Company, including written materials, web designs, software text, graphic materials and original designs produced by the Company;
- (d) Agreements relating to the creation, ownership and/or use of the Company's computer hardware and software;
- (e) Identify any off-the-shelf software used by the Company in the operation of its business;
- (f) Royalty agreements and licenses held by or granted to Company relating to the use of IP;
- (g) Agreements or arrangements for sharing of IP, technology or research and development, including product development agreements, technical assistance agreements or arrangements and confidentiality agreements between the Company and any affiliates or third parties;
- (h) Identify all employees who have recently been hired from, or left to join, competitors;

- (i) Describe policies and procedures for protecting trade secrets; and
- (j) Identify all domain names and web sites.

2) Describe all pending or threatened infringement actions by or against the Company.

### The America Invents Act of 2011

Consideration of a company's IP in India would not be enough, as IP protection in the world's great economies is also essential. The U.S. is now operating under a new patent law (the America Invents Act of 2011 ["AIA"]). Among several changes in the U.S.'s patent laws, the AIA amended the previous law and introduced a "first to file" system (versus "first to invent"), which was designed to bring the U.S. in conformity with the rest of the world (including India). The amendment was not without its detractors who thought that it would create a "race" to the patent office that only big business could afford to run. In practice, however, these fears have proven to be unfounded.

This is so partly because the AIA contains streamlined challenge provisions for *Inter Partes* ("Between the Parties") Review ("IPR") which enables startups and small businesses to cost-effectively challenge the validity and enforceability of issued patents. This avenue was previously prohibitively expensive. The prior system of patent procedures was a costly, time consuming and arduous process that inhibited the development of new companies with innovative products. A patent is typically at the heart of any innovative technology or new idea. The AIA streamlines the process for challenging validity or infringement of patent. This levels the playing field for new players, particularly budding entrepreneurs. For example, 20 proceedings were filed in just the first month that the AIA came into effect. This has been a steadily-increasing trend—more than 180 proceedings were filed in June 2014.

In conclusion, recent developments in law and political policy in India and the U.S. have led to

increased confidence within the venture capital community in both countries, especially for small start-ups. This new environment and a recognition of the critical importance of intellectual property protection will help drive the engine of further innovation because it protects what is innovated— it is a self-fulfilling circle of encouragement.

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## VENTURE CAPITAL AND LEVERAGED BUY-OUTS IN INDIA - THE ROAD AHEAD

By *Abhijeet Sonawane and Bhanudey Singh Kanwar*

Venture capital and private equity funds have the advantage of not only infusing an entrepreneurial enterprise with funds but also of ensuring that the enterprise is managed efficiently. As such, VCs oversee the systemic stability of ventures by ensuring market efficiency, formation of new capital and adherence to applicable laws. Investment opportunities are typically found in starts ups as well as in distressed enterprises. In India, however, venture capital funds in both areas are burdened by a wide range of restrictive laws and regulations. The Securities and Exchange Board of India (“SEBI”), the securities market regulator in India, acting under authority of the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) lays down the regulations governing the investment of venture capital funds.

The general trend among venture capital funds has been to invest in profit generating companies/projects. However, in recent times the Indian economy has also witnessed a significant rising interest in investment in non-performing assets. For example, funds have sought alternative investments, such as leveraged buy-outs (LBO) of distressed enterprises. Such investments are funded by bank borrowings collateralized by the assets of the bought-out distressed enterprise. Some argue that by restructuring and restoring distressed enterprises to health, the LBO model helps the economy as a whole, especially in a developing country like India. Others counter that LBOs are ultimately corrosive to the development of the economy as a whole because of the harsh measures imposed upon targeted firms in the process of restructuring them. The possibility of what it sees as diversion of borrowed funds into non-performing firms has been of concern to India’s central bank, the Reserve Bank of India (RBI) because of fears that such excessive and somewhat speculative lending by banks for LBOs could put a

severe strain on the overall health of the Indian economy.

The RBI has sought to recognize and address the root causes of what it sees as dangerous new trend into non-performing assets. The concern is based on the fact that banks play a significant role in the Indian economy when it comes to corporate borrowing. As a result, Indian law currently prevents venture capital funds from making investments in leveraged buy-outs, which is a globally accepted model. Specifically, Indian regulations prohibit investment of funds procured by taking loans from banks/financial institutions that are collateralized by the assets of the investee company. There are signs, however, that the RBI may be reconsidering its position regarding LBOs. In December 2013, the RBI released a Discussion Paper on “*Early Recognition of Financial Distress, Prompt Steps for Resolution and Fair Recovery for Lenders: Framework for Revitalizing Distressed Assets in the Economy.*” The Discussion Paper introduces the concept of the regulated leveraged buy-out to India.

### LEVERAGED BUY-OUTS IN INDIA

Globally, in a leveraged buyout (“LBO”) the objective is to acquire an undertaking without infusing considerable capital. Rather, the aim is to utilize the assets of the target undertaking as collateral to secure a loan from banks/financial institution to finance the acquisition. The Discussion Paper, in its current form, introduces the LBO model of investments as a way to revitalize sick/distressed companies. It proposes to liberalize the regulatory treatment of asset sales by allowing LBOs for specialized types “stressed companies”. The LBO model initially would allow funds and sector specific companies to play an active role in revitalizing the stressed assets market.

## PREVAILING RESTRICTIONS IN INDIA

Venture capital funds face the following restrictions under the prevailing laws in India:

- To protect the interests of domestic companies, the RBI prohibits banks and financial institutions from granting loans for acquisition of shares in any Indian company. However, domestic banks are allowed to advance loans to Indian companies for acquisition of shares in foreign joint ventures and wholly owned subsidiaries, subject to certain conditions as may be prescribed by RBI.
- The Foreign Investment Promotion Board (FIPB), the apex authority regulating foreign direct investment in India, prohibits investors from acquiring loans from domestic banks for acquisition of shares in an Indian company.
- AIF Regulations also restrict funds from acquiring loans directly or indirectly from banks/financial institutions or to engage in any form of leverage, except for meeting temporary funding requirements for a time period not exceeding 30 days, for a maximum of four occasions in a year, and not for more than ten percent of the corpus.
- Section 67(2) of the Companies Act, 2013 which came into effect on April 1, 2014, restricts public companies from providing any financial assistance to a person for the purpose of or in connection with a purchase/acquisition of its shares. Further, companies are restricted from providing any guarantee, loan or any security of any nature to an investor whether directly or indirectly.

In view of these restrictions, most venture capital funds are weighed down with a barrage of regulatory and compliance requirements that are not in sync with the model prevalent in other developed economies. If the LBO model is ever introduced in India, the regulatory restrictions will need to be suitably amended for it to be successful.

Moreover, the Indian Venture Capital Association (IVCA), an association, established to promote the development of venture capital funds in India, though active, is not active enough to adequately represent a large proportion of the funds that are seeking investment opportunities in India. A more pro-active role played by IVCA to promote development of funds would provide them with opportunities that would support entrepreneurial activity and development.

## LEVERAGED BUY-OUTS IN THE U.S.

By comparison, U.S. laws provide much greater leeway to venture capital funds. The LBO model in U.S. is governed by federal securities laws and regulations such as the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Venture capital funds are also governed by the regulations promulgated by the Securities and Exchange Commission (SEC).

U.S. laws permit the LBO model by not imposing the kinds of prohibitions, restrictions or regulations seen in India. U.S. laws focus on transparency and accountability. The U.S. experience has shown that LBOs have benefited target or “investee” companies and are not as harmful as Indian regulators seem to believe.

## HOPE FOR REGULATORY REFORM

The corporate and financial sector in India supports deregulation and is eager to be permitted to use the LBO model of investment by securing loans from foreign institutions when investing outside India. The LBO model is particularly appealing given that the corporate debt market in India is also constrained by regulatory restrictions. As a consequence, most major funds in India tend to look for opportunities in investor-friendly countries which have favorable regulations and are more conducive to LBO and other alternative investment models. The laws of the U.S. are also conducive for investment in start-ups and small

scale industries. By contrast, the prevailing laws in India for start-ups, and the small/medium scale industries are yet to match U.S. or global standards.

Despite India's drawbacks, there is a ray of hope for the LBO model given that the Discussion Paper proposes allowing it in India. The LBO model as proposed in the Discussion Paper is restricted to stressed companies alone. It would help if the proposal were all-encompassing so as address the needs of all stakeholders. This would include creating an environment to limit protracted litigation which only acts as yet another roadblock in making investment decisions. Nonetheless, the RBI through the Discussion Paper has shown a willingness to reconsider its opposition to the LBO model in India. Permitting LBOs would invite foreign investments and also ensure that the economy is not burdened by distressed assets and unavailability of capital.

As distressed assets are an immediate concern for the recovery of the Indian economy, the RBI has been wise to review its initial opposition to LBOs and to test their suitability in India, albeit in a restricted manner. A loosening of the regulatory restrictions on LBOs would encourage funds to invest in them thereby making them more cost effective and attractive.

LBOs have been successful in U.S. Once allowed, how effective they will be in India remains to be seen.

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## INDIA'S BUDGET 2014: WHITHER AMENDMENTS TO TAX LAWS APPLIED RETROACTIVELY?

By Mukesh Butani, Sumit Singhanian and Rahul Yadav

The new BJP-led government of Prime Minister Narendra Modi presented the Union (or Federal) budget to Parliament in July 2014, barely two months after taking office. The budget was presented in the backdrop of unprecedented expectations and business aspirations caused by hopes that, at last, the new government would live up to its campaign promises to revive India's economy. Faced with difficult macro-economic challenges and daunting deficit targets, the new government had a tough task at hand. Nevertheless, Finance Minister Arun Jaitley managed to pull off a delicate balancing act between economic growth and an agenda of reforms in government expenditure, which was evident in his long speech to Parliament.

Broadly, his key announcements were short-to-medium term vision-based and aligned to the theme reflected of the railway and the finance budgets such as big ticket investments based on private and public sector collaboration, and high technology induction and experimentation with new financial products and sources. The Budget scores well on regulatory policy front, too, by elevating the composite Foreign Direct Investment (FDI) cap to 49 percent in the defense and insurance sectors. And the roll-out of several infrastructure projects under the public-private-partnership model should catalyze new investments in this capital-starved sector.

The new budget included a clear commitment to tax policy reforms. The Budget's Economic Survey 2014 underlined the need for structural reforms in Indian tax policy and administration. These reforms are designed to move away from the present industrial-policy based tax system to a simplified and more equitable regime. Significantly, Mr. Jaitley mentioned two tax policy reforms—the introduction of

a Goods & Services Tax (GST) and a Direct Taxes Code (DTC), but unfortunately he failed to provide a definitive time frame for the transition.

### No Intention to Repeal Retrospective Tax Legislation

On the wider tax policy reform agenda, the Finance Minister recognized the pressing need to provide certainty and a robust, yet investment-friendly, tax regime. This includes resolving the tension between the legislative and judicial viewpoints on retrospective amendments of tax laws effecting indirect transfers. Retrospective tax law (i.e., laws which have retroactive effect) have been referred to as "tax terrorism" and "tax adventurism," on the part of the outgoing Congress Party-led government. However, in the run-up to the budget, one could only wonder if the new government would practice what it preached by repealing the most controversial retrospective pieces of legislation in recent times concerning taxation of indirect transfers. This legislation has often been described by the investors' community as a knee-jerk reaction to nullify a Supreme Court decision in the celebrated Vodafone cases opposed to a well-thought tax policy action. (See *Vodafone Int'l Holding B.V. vs. Union of India* [2012] 341 ITR 1 [SC]).

### The Story So Far

The Finance Act 2012, introduced multiple amendments having retrospective effect—specifically sections 9 and 2(47) of the Income Tax Act ("the Act"). These amendments were legislated in the form of Explanations appended to section 9 of the Act. The stated legislative intent underlying the amendments was to bring within the ambit of Indian taxation, the sale of shares of a foreign company if such shares

derive 'substantial value' from underlying assets located in India. The 2012 amendments to charging provisions had the effect of rendering a Vodafone transaction and others like it liable to tax in India, with retrospective effect. In short, under the garb of retrospective clarificatory amendments, the legislature nullified in a single stroke long-standing judicial precedents which had recognized the separation of powers between the legislative and judicial branches. These amendments which were enacted to nullify the Supreme Court's verdict in the *Vodafone* case were widely criticized as an unconstitutional attempt of the Legislature to usurp judicial independence.

The legislative competence for enacting retrospective legislation(s) and constitutional and judicially recognized parameters within which such laws must be enacted have been discussed in our previous article. Butani, Mukesh and Rahul Yadav. "Does retrospective legislation compromise judicial independence? The constitutionality of the Vodafone legislation." *India Law News* Vol. 4 Issue 1 Winter/Spring 2013: 1. We opined that the retrospective amendment of taxation of indirect transfer could not be held to be clarifying the intent of the Act, so as to include the off-shore sale of shares by one foreign company to another foreign company (such as Vodafone) within the ambit of section 9 of the Act. Such amendments ought to be regarded as substantive amendments causing levy of new charge of tax and thus, could not be given a retrospective operation as per settled legal principles. The following developments have taken place since then.

### **Taxpayers Move Court to Challenge The Constitutional Validity Of The Amendments**

In the wake of the retrospective amendments, certain taxpayers moved the High Courts of appropriate jurisdiction, by filing writ petitions under Article 226 of the Constitution of India, challenging the constitutional validity of such amendments. McLeod Russel (India) Limited, SABMiller Limited (an Australian Company) and IHC Mauritius Corporation have filed writ petitions before the Calcutta and Bombay High Courts, respectively. Decisions are pending in these, which was the reason the finance minister gave in his budget speech for no action for the time being by the legislature on this issue. This is

keeping in line constitutional convention not to intervene in matters before the judiciary. Most observers believe that the new Government could have acted boldly and repealed the law. As the constitution empowers the legislature to legislate a retrospective clarifying law, it includes the power to repeal any law as was done with respect to the Fringe Benefits Tax – a law which was repealed four years after it was passed.

### **Government Sets up Shome Panel**

The retrospective amendments of 2012 evoked strong reactions from investors, prompting the then government to set up an expert panel under the chairmanship of eminent tax policy commentator, Dr. Parthasarathi Shome. The Expert Panel's primary recommendation was that provisions relating to taxation of indirect transfers should be implemented to have prospective effect. It was noted in the Panel's report that the retrospective amendments were not clarificatory in nature; instead, it had the effect of widening the tax base. The Panel recommended that its application be made prospective so as to bear the principles of equity and probity in the implementation of commonly recognized taxation principles.

However, recommendations of the Expert Panel were not implemented and translated in the statute book by way of supplementary legislation. Non-implementation of these recommendations was seen as another instance of indecisiveness and lack of sensitivity towards investor sentiments by the former government. In effect, the 2012 law was left toothless, though, it did not prevent certain segments of the tax administration from pursuing recovery of taxes on the basis of the impugned law.

### **Vodafone Initiated Arbitration Under the India-Netherlands Bilateral Investment Treaty ("BIT")**

In April 2012, Vodafone invoked the dispute settlement process under the India-Netherlands Bilateral Investment Treaty (BIT). Under the mechanism provided under BIT, which follows the United Nations Commission on International Trade Law (UNCITRAL) rules, Vodafone initiated conciliation with the Government of India. Even if the new government agrees to arbitrate, it remains to be seen whether tax disputes are covered under

international arbitration, despite the fact that the primary objective of such BITs is to protect foreign investment.

### **The New Government Has Shied From Repealing The Retrospective Amendment And Has, Instead, Set Up A High Level Committee For Investigation Of Disputes**

In his budget speech, the Finance Minister stated that the new government intended to legislate or enforce retrospective amendments with utmost caution and judiciousness, keeping in mind the impact on the overall investment climate of the country. This is important particularly in the wake of the over 150 retrospective amendments that have been enacted in the last decade. The majority of these were under the garb of clarificatory amendments, which unsettled established tax principles and precedents. At a policy level, the government's stated reluctance to introduce retrospective amendments is an enormous relief and is consistent with its policy of providing a stable tax regime. This augurs well for the investor community at large.

Contrary to popular expectations, the new government stopped short of repealing or amending the law on taxation of indirect transfers to make it applicable only prospectively. Instead, the government has proposed to constitute a high level committee under the aegis of the Central Board of Direct Taxes (CBDT), which is the highest administrative authority responsible for administration of direct tax laws in the country. The CBDT would scrutinize all fresh cases that could fall within the ambit of the retrospective amendments of 2012, before the Revenue Department could seek to enforce tax payments under retrospective legislation. Such a move should bring a degree of stability to the way Revenue decides to pursue tax claims in indirect transfer cases. Still, investors will continue to feel stranded in the absence of legislative clarity on the scope of such amendments.

The new government probably shied away from repealing the retrospective amendment for two reasons. The more obvious one is that it is the custom for the legislature to let challenges to the constitutional validity of legislation to work their way through the judicial system before delivering a legislative riposte. Second, while there is no question as to the

legislature's power to enact and repeal laws, the new government probably did not wish to risk a political outcry barely two months in office by repealing retrospective amendments enacted by its predecessor government.

Investors have already taken tentative notice of the government's announcement to set up a high-level committee to scrutinize cases arising out of retrospective amendments. Cairn India, one of the litigants challenging the constitutional validity of the amendments, has withdrawn its petition from the Court—ostensibly to pursue settlement by waiting for the CBDT's high-powered committee to weigh in on the controversy. This is an indication that the measures taken by the new government have been well received and that others in the investor community may well be prepared to place its trust in the new government's stated intention to exercise caution in enforcing retrospective legislation.

In sum, despite great expectations from the new government, investors continue to be cautiously optimistic that measures expressed in the new budget regarding fiscal consolidation and socio-economic reforms will translate into further long term macro-economic reforms in next year's budget. Investors also remain hopeful, as they wait and watch, that either the judiciary or the legislature itself will jettison the controversial retrospective application of the law of indirect transfer taxation. There are going to be more twists and turns in this story before the matter is resolved.

### **Taxation of 'indirect transfers' hogs the limelight at IFA's 68th Congress 2014s held in Mumbai October 12 to 17, 2014**

Legislation to tax 'indirect transfers' has come in sharp focus globally, following the high-stake tax disputes in cases such as *Vodafone* and *Chongqing* case reported in India and China respectively. The subject received spirited attention at 68th Congress of the International Fiscal Association (IFA) held in Mumbai earlier this month. Panels of experts from divergent jurisdictions (India, Chile, the Netherlands and Australia) debated the implications of indirect transfer taxability under the respective domestic legislation, key tax policy-related concerns including

extra-territorial reach of domestic legislation; divergent country practices and implementation of domestic legislation without disregarding tax treaty provisions (the latter panel was chaired by co-author of this article, Mukesh Butani). Two key aspects of the debate that emerged were (a) whether and to what extent the customary international law could constrain a jurisdiction to enforce the indirect tax legislation, if the taxation in one of the treaty partner countries is contrary to generally accepted taxation principles or to the provisions of a tax treaty, and (b) whether constitutional law empowered the legislature to enact legislation with retrospective effect to levy tax, and if yes, whether such retrospective law could unilaterally usurp tax treaty provisions.

Arguably, there are no immediate answers and it is, therefore, imperative that the respective jurisdictions, while enacting complex legislation in international tax matters, adapt their approach to international conventions and best practices to avoid embroiling taxpayers in frivolous disputes.

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**THE EFFECT ON TENANCY OF DEMOLITION AND DESTRUCTION OF RENTED PREMISES**

The Supreme Court of India has held recently that the destruction of a rented building does not terminate the lease so long as the land on which the building stood continues to exist. *M/S Shaha Ratansi Khimji & Sons vs. Proposed Kumbhar Sons Hotel P. Ltd*, 2014 (8) SCALE 455.

The respondent had purchased 11/16<sup>th</sup> of the disputed property through two sale deeds in 1971 and 1978. Subsequently, in 1990, the respondent purchased the remaining portion of the property from the owner, to whom the appellant was paying rent as a tenant.

Further, the respondent had started digging in preparation of constructing a hotel when he told the workers of the appellant to vacate the warehouse, which the appellant was renting from the previous owner. As a result of this work, the walls of the warehouse collapsed.

The tenant eventually filed a lawsuit in the civil court, which dismissed the claim holding that the sale of the land to the hotel developer extinguished the tenant's rights in the premises. Subsequently, the appellate court, and eventually the Bombay High Court, affirmed the trial court on the ground that the appellant's tenancy had been extinguished by the sale, and thus the appellant had failed to state a claim for which relief could be granted. The tenant then filed a petition for a writ of certiorari to the Supreme Court, which was granted.

Prior to this case, the Supreme Court had issued two prominent, though contradictory, judgments addressing the scope of a tenant's rights in destroyed buildings. On the one hand, in *Vannattankandy Ibrayi v. Kunhabdullah Hajee*, ([2001] 1 SCC 564), the Court held that tenancy ended with the destruction of a building. On the other hand, in *T. Lakshmi pati v. R. Nithyananda Reddy* ([2003] 5 SCC 150), the Court held that even if a building is destroyed or demolished, the lease does not end so long as the land beneath continues to exist (which, of course, it would in most imaginable

circumstances). Both cases had been decided by different benches of two justices each.

In light of these conflicting precedents, in *Proposed Kumbhar Sons Hotel*, the Supreme Court granted certiorari and referred the case to a bench of three justices which overruled *Vannattankandy Ibrayi* and upheld *T. Lakshmi pati*. The Court held that the demolition and destruction of the property subject to the tenancy did not extinguish the lease. The Court further explained that the respondent had merely purchased the right and interest of ownership of property, which remained subject to the tenant's leasehold interest. Therefore, the lease persisted even after the respondent purchased the land because the acquisition of ownership rights did not include the tenant's leasehold interest, which had been expressly carved out by the lease. Accordingly, the Supreme Court directed the respondent to pay a sum of ₹2 million to the tenant as compensation for depriving him of the use of his leasehold interest in the property for two months with interest at six percent accruing from the date of the judgment.

**THE SUPREME COURT LIMITS THE CIRCUMSTANCES UNDER WHICH AN OPEN OR PUBLIC TAKEOVER OFFER FOR SHARES MAY BE WITHDRAWN**

In *Securities & Exchange Board of India v. Akshya Infrastructure Pvt. Ltd.* (AIR2014 SC 1963), the Supreme Court has held that a corporation cannot withdraw an open (public) offer for shares on the grounds that the offer has become uneconomical or lacks commercial reasonableness.

Akshya Infrastructure Pvt. Ltd, a part of the Promoter Group of MARG Limited (the "Target Company"), had made several acquisitions between 2006 and 2010 in excess of the five percent creeping acquisition limit permitted under the Substantial Acquisition of Shares and Takeovers Regulations (the "Takeover Regulations"), and, therefore, was required to comply with the provisions of Regulation 11 of the Takeover Regulations under which share offers of more

than five percent must be made in the form of a public announcement.

In 2011, Akshya made a voluntary open offer through a public announcement published in several major national newspapers in compliance with Regulation 11. However, due to certain events, in 2012 Akshya expressed its intention to withdraw the open offer pursuant to Regulation 27 of the Takeover Regulations. Akshya justified its withdrawal of the open offer on the ground that the transaction was no longer economically expedient or commercially reasonable.

In late 2012, the appellant, the Securities and Exchange Board of India ("SEBI") raised questions and concerns to Akshya about the proposed withdrawal. SEBI took the view that permitting withdrawals of public offers is harmful to shareholders who have accepted such offers. Akshya challenged SEBI's comments before the Securities Appellate Tribunal (the "SAT") alleging that SEBI's delay in forwarding its comments and concerns made the offer economically unviable. The SAT allowed Akshya to withdraw the open offer and to deposit an escrow amount to cover the amounts involved.

Aggrieved by decision of the SAT, SEBI appealed to the Supreme Court. A Division Bench of two justices found that Akshya had acquired shares in excess of the five percent creeping acquisition limit. The court also found that Akshya had failed to comply with Regulation 11, but held that the SEBI was justified in taking the non-compliance into consideration when assessing the feasibility of the public offer made in 2011. In *dicta* the court also criticized SEBI for its 13-month delay in issuing its letter of comments on the offer letter.

Furthermore, the Court held unequivocally that Regulation 27 precludes any corporation from withdrawing a public offer regardless of whether the offer is voluntary or triggered by Regulation 11. However, the Court acknowledged a narrow exception to this prohibition; valid withdrawals must satisfy the requirements set forth in Regulation 27(1)(b), (c) and (d). The Supreme Court concluded that as there is no distinction between a triggered public offer and a

voluntary public offer, both types of offers are governed under the same prohibition.

The Supreme Court rejected Akshya's contention that *Nirma Industries Ltd. & Anr. vs. SEBI* ([2013] 8 SCC 2), was distinguishable on the facts. In *Nirma Industries*, the Court had held that withdrawal of an open offer under the Takeover Regulations is permitted, but only in the narrowest of circumstances, such as a statutory bar to the offer. Economic hardship is not sufficient ground for withdrawal of an open offer.

Accordingly, the Court reversed the order of the Securities Appellate Tribunal and prohibited the Akshya from withdrawing its open offer. The decision reiterates that open takeover offers are made for the benefit of the shareholders of the target, and cannot be withdrawn except in the narrowest of circumstances. It puts the offeror on notice that it must be confident of seeing the offer through and assume the risk of unanticipated events.

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**INDIA LAW NEWS RECEIVES THE AWARD FOR OUTSTANDING  
COMMITTEE NEWSLETTER OF 2014**



*India Law News Editor-in-Chief, Bhalinder L. Rikhye (second from left) with Michael L. Balistreri, Editor-in-Chief of Europe Hot Topics Newsletter, which was also recognized as Outstanding Newsletter of 2014, with Section of International Law Chair Marcelo Bombau (far left) and Chair-Elect, Lisa J. Savitt (far right), at the awards presentation at the Harvard Club, Boston, on August 7, 2014.*

The award was shared with the Europe Committee's Hot Topics Newsletter, Michael L. Balistreri, Editor-in-Chief. The awards presentation was held at a luncheon at the ABA 2014 Section of International Law Retreat on August 7, 2014 at the Harvard Club of Boston. With India Committee Co-Chair Richa Naujoks in attendance, India Law News Editor-in-Chief, Bhalinder L. Rikhye, accepted the award on behalf of the India Committee. Mr. Balistreri accepted the award on behalf of the Europe Committee.

Congratulations to the India Committee, and the authors, guest editors, co-editors and desktop publisher who make the *India Law News* a rich source of information on the current laws of India!

## SUBMISSION REQUESTS

### Annual Year-in-Review

Each year, ABA International requests each of its committees to submit an overview of significant legal developments of that year within each committee's jurisdiction. These submissions are then compiled as respective committee's *Year-in-Review* articles and typically published in the Spring Issue of the Section's award-winning quarterly scholarly journal, *The International Lawyer*. Submissions are typically due in the first week of November with final manuscripts due at the end of November. Potential authors may submit articles and case notes for the India Committee's Year-in-Review by emailing the [Co-Chairs](#) and requesting submission guidelines.

### India Law News

*India Law News* is looking for articles and recent Indian case notes on significant legal or business developments in India that would be of interest to international practitioners. The Winter/Spring 2015 issue of *India Law News* will carry a special focus on Trade Law. Please read the Author Guidelines available on the [India Committee website](#). Note that, *India Law News* does not publish any footnotes, bibliographies or lengthy citations. Submissions will be accepted and published at the sole discretion of the [Editorial Board](#).

## INDIA COMMITTEE

The [India Committee](#) is a forum for ABA International members who have an interest in Indian legal, regulatory and policy matters, both in the private and public international law spheres. The Committee facilitates information sharing, analysis, and review on these matters, with a focus on the evolving Indo-U.S. relationship. Key objectives include facilitation of trade and investment in the private domain, while concurrently supporting democratic institutions in the public domain. The Committee believes in creating links and understanding between the legal fraternity and law students in India and the U.S., as well as other countries, in an effort to support the global Rule of Law.

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### BECOME A MEMBER!

Membership in the India Committee is free to all members of ABA International. If you are not an ABA International member, you may become one by signing up on the [ABA website](#). We encourage active participation in the Committee's activities and welcome your interest in joining the Steering Committee. If you are interested, please send an email to the Co-Chairs. You may also participate by volunteering for any of the Committee's projects, including editing a future issue of the *India Law News*.

Membership in the India Committee will enable you to participate in an online "members only" listserv to exchange news, views or comments regarding any legal or business developments in or concerning India that may be of interest to Committee members.

We hope you will consider joining the India Committee!

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### UPCOMING SECTION EVENTS

#### Conference

#### A Victory for Freedom and Democracy: 25 Years after the Fall of the Iron Curtain

Date: December 04, 2014

Time: 12:00 PM - 1:30 PM ET

Format: Teleconference

#### ABA Section of International Law Spring 2015 Meeting

Date: April 28 - May 2, 2015

Hyatt Regency on Capitol Hill

Washington, D.C.

#### LEADERSHIP (2014-2015)

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