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INDIA LEGAL UPDATE is a journal of Rajani, Singhania & Partners which offers a legal perspective on the new business climate and opportunities in India in keeping with the existing laws, current happenings and events in Corporate India.

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[www.rsplaw.net](http://www.rsplaw.net)

Dear Reader,

Welcome to the September 2014 issue of India Legal Update!

It is an honour and a pleasure to share with you that our Managing Partner Mr. Ravi Singhania has been elected to the Governing Body of the Indian Council of Arbitration (ICA). ICA has been one of the pioneers in promoting the cause of arbitration in India. In the recent times, we have witnessed a surge in International trade and commerce that has generated the importance of arbitration in commercial life. Ravi's new role will contribute significantly towards this end and endeavor ICA to focus on this aspect.

In this edition, we have discussed about how the real estate sector has evolved itself and the investments have changed from equity to structured debt primarily through issue of non-convertible debentures ("NCD"). Over the last couple of years, there has been an increasing dependence on Non-Banking Financial Companies ("NBFC") for funding in the real estate sector. Read about it all in our lead article 'NCD through the NBFC Route - Hot Pie of the real estate sector'.

Recently, the National Consumer Commission granted Relief to Resort Condominiums International, popularly known as RCI on the Basis of Lack of Privity of Contract. In our Court Room feature, we have discussed the challenges faced by RCI.

As always, we will endeavor to highlight the legal developments which you would find interesting and useful.

Look forward to your suggestions and feedback at [info@rsplaw.in](mailto:info@rsplaw.in)

Best Regards,



**Shilpa Shah**

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# Legal Suite

## NCD through the NBFC Route - Hot Pie of the real estate sector

In the last decade, the real estate sector has grown rapidly in India and has moved in the direction of being a more organized sector, though a lot more needs to be done. The government has allowed Foreign Direct Investment ("FDI") in the real estate sector in 2005 and put in place regulations governing the influx of the FDI. With the opening up of the FDI in real estate in 2005 there has been a significant rise of Private Equity/FII investment in this sector.

Pursuant to the partial liberalization, several investments by both domestic and foreign funds took place at entity levels and project levels. However, the real estate sector has been struggling to raise capital post 2009 as FDI has slackened due to the global economic meltdown. The current environment is also not conducive for raising new funds from the public market. With the increase in the Non-Performing Assets ("NPA"), the banks too are not readily lending finance to the real estate sector. To add to the woes, since external commercial borrowing is not allowed in the real estate sector, borrowing money from outside India is not an option. Pending further liberalization, the industry has evolved itself and the investments have changed from equity to structured debt primarily through issue of non-convertible debentures ("NCD").

Over the last couple of years, there has been an increasing dependence on Non-Banking Financial Companies ("NBFC") for funding in the real estate

sector. Typically in a NBFC structure an offshore investment fund sets up a NBFC as a loan company in India, which then lends to the real estate companies. These NBFCs usually lend through loans or through NCDs.

NBFC are considered secured lending vehicles since they are registered with the Reserve Bank of India and governed under the RBI Act, 1934. In order to qualify as a NBFC, the Indian company needs to undertake certain specified activities such as receiving deposits, lending, financing, acquisition of shares or other securities, hire-purchase, etc. RBI has laid down certain key criteria's which NBFCs are required to comply with, which inter alia includes:

- Maintenance of minimum Net Owned Funds (NOF);
- Requirement for creation of a Reserve Fund; and
- Compliance with Capital Adequacy Norms/ Group Concentration norms.

As per the extant laws, foreign investment in NBFC up to 100% is allowed under the automatic route. However, where such NBFCs are engaged in undertaking certain specified activity in India (as listed in the FDI Policy) they need to comply with minimum capitalization norms as set out below:

FDI in (%)	Minimum Foreign Investment
Up to 51%	USD 0.5 Million, to be brought upfront
Above 51% up to 75%	USD 5 Million, to be brought upfront
Above 75% up to 100%	USD 50 Million, of which USD 7.5 million to be brought up front and the balance in 24 months.



NBFC being incorporated as domestic entity encounters less regulatory uncertainty as compared to the regulatory approach towards foreign investment. This also allows an NBFC the flexibility to lend to any sector without any sectoral restriction.

The investment in real estate sector through the NBFC route has been advantageous to the investors. As unlike the Compulsorily Convertible Debentures (CCDs) structure where there is a cap on interest rate i.e. SBI PLR plus 300 basis points, there are no such restrictions on the interest rate on NCDs. In addition these NCDs are structured in such a manner that it would provide fixed rate of return to the investors, which in turns allows a steady flow of income to investors through regular interest payout. The Investors are also able to capture the upside in a deal by having a redemption premium on the NCDs upon exit. Further, the current FEMA regulations do not permit security creation in favour of non-residents without prior government approval. On the other hand, in the case of a NBFC even though owned by a non-resident creation of security against NCD is permitted since it is a domestic entity.

The repatriation lock-in on the investment amount being brought in as FDI are not applicable to the NBFCs and thereby giving it free accessibility and easy exits into the markets. Further, other conditions such as minimum development requirements are not applicable to NBFC. For instance, NBFC could invest in listed NCDs in a real estate project which has a development potential of only 20,000 sq. mtrs. which under the current FDI regulation needs to have a minimum development potential of 50,000 sq.mtrs.

NBFC being a domestic entity, is taxed under the Income Tax Act, 1961 ("IT Act"). NBFC itself is subjected to tax to the extent of interest income so received on the loans/NCDs subject to deductions that the NBFC may be eligible in respect of interest pay-outs made by NBFC on the instruments issued to its offshore parent.

The requirement for adhering to the strict credit concentration norms as set out in Regulation 18 of the Non-Banking Finance (Non- deposit Accepting) Directions, 2007, which vary depending on the type of NBFC, can also be challenging for an NBFC to

leverage the capital available to them for the purpose of making loans and investment. As per these regulations a systematically important NBFC (being an NBFC not holding public assets and having total assets of Rs. 100 Crores and above in its last audited balance sheet) is not permitted to lend or invest in any single company exceeding 15% of its owned funds and in single group company exceeding 25% of its owned fund. However, if a systematically important NBFC is lending and investing (both together) then the limit is increased to 25% of its owned fund to a single party and 40% of its owned fund to single group of parties. These concentration norms can be dispensed with by an application to the RBI subject to the NBFC not accessing public funds and not being in the business of issuing guarantees.

Unlike in equity deals where the investor rights are well protected with adequate affirmative voting rights, management control etc., in NBFCs funding through the NCD route only mere lending rights in the developer company are available. The NBFC invested through the NCD generally do not get any management right or veto rights. However, it could possibly secure certain veto rights under the terms of the loan/subscription agreement.

Though investment in NCD through the NBFC route is a win-win situation for both the developers and the NBFC, there are certain challenges in order to achieve a 100% viable mode of investment. NBFCs cannot seek enforcement of their rights under SARFAESI Act. Accordingly, NBFCs have to follow the rigours of court process to enforce their security interest.

With every investor concerned with a desired exit, the exit needs to be well formulated and planned. The offshore investor invested through its NBFC can plan its exit from the NBFC without the intervention of the local real estate developer as would have been required in case the offshore investor had directly invested in the entity of the developer. The offshore investor can part from the fund through strategically selling its shares to another resident or non-resident, buy-back of shares of the foreign investor by the NBFC, by getting the NBFC listed or finally by liquidating the NBFC.

## Court Room

# National Consumer Commission Grants Relief to RCI on the Basis of Lack of Privity of Contract

Resort Condominiums International, popularly known as RCI, was dragged in a legal battle by a consumer<sup>1</sup> which concluded with the National Commission's verdict in May, 2014. Rajani, Singhania & Partners successfully represented RCI at the National Commission.

RCI is a holiday exchange club and facilitates its members only in the holiday exchange system. The RCI affiliates resorts worldwide and provides exchanges within its network to purchase of timeshare weeks of affiliated resorts provided they become members of RCI. RCI does not own any resort anywhere in the world. The RCI exchange programme and the products and services sold by or on behalf of the affiliated resorts including holiday ownerships are also separate and distinct.

In the year 2007, the Complainant raised a dispute with the District Consumer Forum, Hyderabad, India alleging deficiency in services against M/s Gemawat Resort Ltd., in which RCI was also made a party. The whole case of the Complainant was that it paid money to M/s Gemawat Resort Ltd. towards membership of the resort, "The Village". M/s Gemawat Resort Ltd. failed in providing its services to the Complainant as the resort "Village" was not developed by them. The Complainant alleged in the complaint that it had paid an amount towards purchase of the membership of the resort to M/s Gemawat Resort Ltd. Since M/s Gemawat Resort Ltd was affiliated to RCI, the Complainant also alleged deficiency in service against RCI.

M/s Gemawat Resort Ltd. chose not to contest the matter and was proceeded ex-parte. RCI contested the complaint on the ground that M/s Gemawat Resort Ltd and RCI are distinct and separate entities and that admittedly the money was paid by the Complainant to M/s Gemawat Resort Ltd towards the services to be provided by the resort only. The services provided by RCI were distinct and limited to exchange facilities to be provided to members of affiliated resort as and when requested by the member.

Before the District Consumer Forum, RCI pleaded that there was no privity of contract between RCI and the Complainant for

the development of the resort. RCI carries its operations vide two agreements: Firstly, the is



a resort affiliation agreement between RCI and each affiliated resort on payment of affiliation fee by the resort. Subsequently each affiliated resort submits enrollment application forms of their members to RCI alongwith membership fee for the member's right to participate in the RCI holiday exchange program. Secondly, there is an agreement between the member and RCI termed as the 'RCI terms of Membership', which sets out the legally binding terms and conditions. The 'RCI terms of Membership' particularly provides that RCI is distinct from the affiliated resort, and the services provided by RCI stand separate from those which an affiliated resort is to provide to their respective member. Therefore, RCI does not have any obligation towards the development of the resort.

RCI further submitted that it had, in fact, disaffiliated the resort "Village" as per the contract between RCI and M/s Gemawat Resort Ltd. In spite of disaffiliation of the resort, RCI had allowed the Complainant to continue its membership with RCI for availing benefits of bonus weeks. The Complainant had further availed the facilities of RCI even after the disaffiliation of its resort. Hence, RCI has not failed in providing its services to the Complainant in any manner.

The District Forum adjudicated in favour of the Complainant on the ground that both RCI and M/s Gemawat Resort Ltd. are jointly and severally liable to compensate the Complainant on account of deficiency in services. Since RCI has taken membership fee from the Complainant, it does not become a separate entity. The aforesaid decision was further affirmed by the State Forum. While dismissing the appeal, the State Commission held that RCI was to provide facilities in as much as it has received the membership fee from the Complainant. Hence, RCI is responsible for the deficiency in services to be provided to the Complainant.

<sup>1</sup> (hereinafter referred to as the "Complainant").



The National Commission accepted the submission of RCI and held that the Complainant has failed to show privity of contract between RCI and itself and thus, RCI cannot be held liable for the deficiency in services rendered by M/s Gemawat Resort Ltd.



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## Risks of Crowdfunding

EbC would enable the issuers to raise funds online, up to INR 100 million by issuing equity shares to the accredited investors. A single investor would not be allowed to hold more than 25% stake in a company and the promoters shall be required to maintain an equity stake of minimum 5% for at least 3 years. The investors would have the rights of an equity shareholder as provided under the Companies Act, 1956 [Companies Act, 2013]. Similarly, DbC would enable the issuers to raise funds online, up to INR 100 million by issuing debentures or debt securities to the accredited investors. The debt securities should comply with the requirements of the Companies Act, 2014 [Companies Act, 2013]. A debenture trustee would be required to be appointed by the investor and a Debenture Redemption Reserve of 25% of the value of the debentures would be required to be created. The investors would have the rights of debenture holders as provided under the Companies Act, 1956 [Companies Act, 2013].

### Substitution of Institutional Risk by Retail Risk:

- Entities solicit investments in smaller sums from large number of investors. Hence, the risk taking by VCF/PE (informed investors) is substituted with retail investors, whose risk tolerance level may be very low.

### Risk of default:

- There is no or less recourse to the investors against the issuer, in case of default or fraud;
- There is no collateral (even in case of peer to peer lending), as in case of Corporate Bonds;
- Public funding is sought on the basis of future possibilities as against the clear evidence of a viable existing business model, which is needed under the existing regulations. Investments in companies without viable business model increase the risk of failure and loss to equity investors;
- The risk of failure is further increased by the fact that the funding is potentially by participants who do not have the skills and experience needed to assess the risk before investing/lending.

### Risk of Fraud:

- There is a risk of misuse as well as cyber-security and/or identity theft.

### Central role of the Internet:

- The central role of the Internet and its wide reach would increase the number of persons potentially affected, which can be significantly greater than the traditional means of fundraising;
- Funds could be raised from investors residing at various countries without complying with requirement of local laws of various jurisdictions.

### Systemic Risk:

- Investors may not practice good diversification principles;
- Risk of illiquidity;
- Possibility of Money laundering;
- Risks could become systemic;
- Cross-border implications.

### Information Asymmetry:

- High chances of information asymmetry;
- No monitoring of these platforms;
- Lack of transparency and reporting obligations;
- Possibility of omission of information and misinformation providing;
- Distorted view of the issuer or the actual investment.

### Substitution of Existing Regulatory Framework:

- Peer to Peer Lending acts as a Bank by matching lenders/investors with borrowers/issuers, without complying with any of the rigid requirements of Banks;
- The Disclosure and due diligence involved in Crowdfunding platform cannot be compared with existing framework;
- Further, even private placement requirements have been tightened in India recently.



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## NEWSQUEST

### The Government of India Amends Trademark Rules, 2002

The Government of India has notified the Trademark (Amendment) Rules 2014 vide gazette notification G.S.R. 523(E) dated August 01, 2014. The Government hereby makes the following amendments to the Trademark Rules, 2002:

- 1) The official fee for filing of trademark application in one class has been increased from INR 3500 to INR 4000 effective from the date of notification.
- 2) Additionally the official filing fee for expedited examination has also been increased from INR 12, 500 to INR 20,000 effective from the date of notification.

Pursuant to the said notification the Indian Trademark Office vide circular no. CG/Public Notice/2014-15/51 dated August 7, 2014 has notified that all the agents/applicants who have filed the trademark applications after August 1, 2014 will have to pay the deficient fee by September 30, 2014. The receipt of deficient fee after the aforementioned date shall result in shifting of the filing date to the date of payment of the deficiency.

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### Enhancement of Statutory Wage Ceiling limit by the Government of India

The statutory wage ceiling limit under the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 has been enhanced from INR 6,500 to INR 15,000. The Government issued a notification on enhancement of the statutory wage ceiling limit, minimum pension of INR 1000 per month, 20% additional relief on the amount of assurance benefit under the admissible Employees' Deposit-Linked Insurance Scheme, 1976.

Source: <http://www.rsplaw.net/wp-content/uploads/2014/08/EPF-Salary-Ceiling-Increased.pdf>

**Rajani, Singhanian & Partners are Legal Advisors to FIMI Irrigation in the acquisition of the Water Division business of John Deere India.**

Rajani, Singhanian & Partners advised FIMI Irrigation in the acquisition of the Water Division business of John Deere India. FIMI paid \$160 million for John Deere Water. FIMI Irrigation has now been renamed as Rivulus Irrigation Ltd.

Read more: [http://barandbench.com/content/212/rajani-singhani-and-isa-act-fimi-irrigation%E2%80%99s-purchase#.U\\_\\_zUFLrIV](http://barandbench.com/content/212/rajani-singhani-and-isa-act-fimi-irrigation%E2%80%99s-purchase#.U__zUFLrIV)

## SYNAPSE

**Rajani, Singhanian & Partners advised Globo Emea Holdings and Globo PLC in acquisition of Sourcebits Technologies**

The firm was appointed as the legal counsels to Globo Emea Holdings and Globo PLC in acquisition of Sourcebits Technologies, the global provider of complete enterprise mobility solutions and Software-as-a-Service.

Read more: [http://barandbench.com/comment/47078#.U\\_\\_zLFLrIW](http://barandbench.com/comment/47078#.U__zLFLrIW)

**Mahindra Conveyor appoints Rajani, Singhanian & Partners as Legal Counsels**

Rajani, Singhanian & Partners acted on Tsubaki's acquisition of majority stake in Mahindra Conveyor. Mahindra Engineering & Chemical Products transferred its majority shareholding of 42.5 per cent in Mahindra Conveyor Systems to the Japan-based Tsubakimoto Chain Co whose affiliate Tsubaki Bulk already holds 8.5 per cent in Mahindra Conveyor Systems.

Read more: <http://www.legallyindia.com/Deals-in-brief/dibs-2014-august>

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