CHAPTER 6
PROBLEMS ARISING OUT OF FOREIGN PARTICIPATION

What is Participation? 186
Why Foreign Participation? 188
Various Forms of Foreign Participation 189
Technical Collaboration 189
Financial Participation 194
Participation in Share Capital 195
Rights and Liabilities of Shareholders 203
Outflow of Foreign Capital 204
What is Participation?

What is Participation? The term 'participation' literally means1 'the act of taking a share with others in an activity'. One may participate in a debate, seminar, conference or day-to-day management, e.g., workers' participation in management. Participation, therefore, implies involvement in the relevant matter to be performed jointly by the participants. We, however, are concerned here from the viewpoint of an enterprise. Precisely, we want to look at the participation in share capital of a company. So, the term participation in this context may be interpreted as 'holding of' or 'owning' shares in a company. The shareholders of a company may be classified differently, e.g.,

(a) according to status:
   Individual, and
   Institutional

(b) according to origin of country:
   Indians, and
   Foreigners

(c) according to income-group:
   High-income
   Low-income, etc.

We would take up the case of participation in share capital by foreigners (i.e., having origin outside Indian Union). Foreigner, as per above classification, may be an individual; it may include an institution as well having a legal entity and being registered outside India.

According to the (Indian) Income Tax Act, 1961, the residential status of an individual may be of three types, namely, Resident, Non-resident, Resident and Ordinarily Resident. To be treated as ‘resident’ an individual must satisfy either of the following two conditions as mentioned in Sec. 6(1):

(i) he is physically present in India for 182 days or more in all during the year;

(ii) he was physically present in India for at least 365 days during the last four previous years and is in India for at least 60 days during that year. However, an Indian citizen who resides outside India for earning income and comes to India in any previous year on leave or vacation, would be considered as resident in India if his total stay in India in that previous year is at least 90 days (in place of 60 days).

Any individual who fails to satisfy any of the above two conditions shall be treated as ‘non-resident’.

If an individual, being a resident as above, also satisfies both the following conditions as mentioned in Sec. 6(6), he shall be considered as ‘resident and ordinarily resident’:
(i) he was resident in India in nine out of ten
previous years preceding the previous year, and

(ii) he was physically present in India for at least
730 days during the seven previous years preceding the
previous year. Under Sec. 6(3), a company is said to be
resident in India, in any previous year, if -

(i) it is an Indian company, or

(ii) during that year the control and management of
its affairs is situated wholly in India.

We shall, however, take the term 'foreigner', so far
as foreign participation is concerned, to mean those indi-
viduals or institutions who receive dividend on shares of
Indian companies as non-resident shareholders.

**Why Foreign Participation?**

Dependence on agriculture is one of the prominent
features of Indian economy. This might have hindered the
industrial development in India. Other major reasons for
lack of proper industrial development in India may include
weak technological base and inadequate infrastructure of
production and trade. India naturally depended too much on
others. It adopted import substitution as a strategy for
industrial development and pursued a policy of encouraging
the flow of foreign capital and technology into the manu-
facturing sector in order to fill up the trade and techno-

2. Krishna Bharadwaj, *Production Conditions in Indian Agri-
culture - A Study Based on Farm Management Surveys*,
logy gaps and to accelerate the development process. Consequently, the rapid growth of foreign collaboration in Indian Industry took place since the mid-fifties.

Various Forms of Foreign Participation

There is scope for foreigners to take part in either or both of the following fields of activities as far as foreign participation in Indian enterprises is concerned. The two major forms of foreign participation are:

(i) Technical Collaboration, and
(ii) Financial Participation.

We discuss them in the following paragraphs in a nutshell.

(i) **Technical Collaboration** - According to Second Survey Report, foreign technical collaboration refers to such facilities provided by the foreign partner as technical services, licensing, franchise, trademarks and patents. Increasing industrial productivity can be achieved with modern technology. Modern technology can be

---

imported from foreign enterprises by contractual arrangements. This is generally known as "foreign collaboration" which usually involves payment of royalties and technical fees to the foreign enterprises. These collaboration arrangements may be independent of the other form of participation by such foreign enterprises or may prevail simultaneously, the latter being known as the package form of collaboration. Foreigners generally prefer the package form since it provides them with possibilities of switching payments from one form to another, and also controlling the industries of the developing countries through sustained technological dependence. On the contrary, in India the Government's policy favoured implicit preference for pure technical collaboration as the mechanism of technology transfer. But while implementing the policy the Government had to relax the statutory regulations and controls to a great extent and thus implicitly encouraged the package form. Consequential effect of importing technology in the package form of a high degree is indiscriminate import which in effect means the import of technology embodying inputs. Complex decision-making is, therefore, involved and the cost-benefit analysis of the project and of alternative mechanisms of technology transfer may be of great help to that effect. Another factor which deserves serious consideration in the process of decision-making as to the import of technology is the appropriateness of technology. Here too,

7. Ibid., p. 128.
the foreigners generally prefer to transfer technologies in unaltered form. It may be pointed out that many of the improvements in technology are specific to particular processes of production and are 'localized' in nature. Indian industrial environment is labour-intensive. So imported technologies developed in capital-intensive factor conditions seem to be inappropriate in India if implemented in unaltered form. Thus, before implementing imported technologies they need to be adapted to suit the local conditions. Otherwise technological dualism may creep in. Such adaptation of imported technologies requires strong Research and Development base in India.

The importance of Indian companies developing research in technology is very great since it will not only enable them to know the type and quality of technical know-how offered by foreign collaborators but also help in adapting foreign technology to suit local conditions as well as developing indigenous know-how. Developing indigenous know-how will help India to equip itself with a better bargaining power in determining the terms and conditions offered by foreign collaborators. It is needless to point out that the Research and Development (R&D) base in India is very weak. The view that R&D base is weak in India is based on the data revealed by the Survey conducted by the Department of Science and Technology, Government of India. expenditure

on R&D in India rose from Rs. 1.10 crores10 in 1948-49 to Rs. 448 crores in 1976-77 and to Rs. 520 crores in 1978-79. The figure further increased from Rs. 1680 crores in 1984-85 to Rs. 2180 crores in 1985-86.11 Although the rate of growth in R&D expenditure (per annum) has been exceeding the rate of inflation until 1978-79, in India we are still very much far behind in devoting a recognisable proportion of GNP (Gross National Product) to R&D efforts. Thus, whereas the average investment in R&D as a percentage of GNP was 1.13 per cent in 25 countries of the world around 1972-76, India's rate (0.6) has been about half of this world average.12 In 1985-86, 1 per cent of the GNP was devoted for the first time to R&D and other related activities in the country (India).13 The survey report of the Reserve Bank of India (RBI), referred to earlier, revealed one interesting feature. More than two-thirds of the companies covered by the survey had set up their R&D departments after their technical collaboration agreements came into force. Again, the proportion of companies having R&D set up was much higher among those with technical collaboration arrangements than in the case of companies having

only financial participation. This was probably owing to the availability of newer technology from the collaborators. Studies have shown that Indian industries in general spend a relatively very small proportion of their sales on R&D; and foreign subsidiaries and foreign-controlled ventures are by and large even less conscious of in-plant R&D. There is a calculated reluctance on the part of foreign collaborators to undertake or assist in undertaking R&D within the plant in India. Indigenously developed technology has not been preferred by some Indian industries themselves owing to the obvious problems involved like lack of experience and consequent high cost. But considering the long term benefits the public policy should be so designed that it would provide protection to the infant indigenous technology. In the absence of such preferential treatment, the Indian technological base has remained small, under-utilised and stagnant. Foreign collaboration thus tends to pose the danger of perpetuating technological dependence on advanced countries. Technical collaboration involves payment of only royalties and technical fees to the foreigners, as stated earlier, which has no bearing on the erosion of capital of the Indian enterprises. So we may refrain from a critical analysis to that effect so far as this type is concerned.


Financial Participation - Foreign financial participation means, as stated earlier, participation by foreigners in rendering the financial assistance to Indian enterprises. They may 'take part' by providing loans or by subscribing to the share capital of an enterprise. The need for foreign participation has been described at the outset. The quantitative significance and the growth of financial participation is partially reflected in increments in the various forms of NRI investment in India during the period March, 1985 to March, 1987. The amount of NRI investment in India increased significantly as will be evident from Table 1.

Table 1

<table>
<thead>
<tr>
<th>Year (end of March)</th>
<th>Amount of NRI investment in India (Rs. crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Portfolio investment</td>
</tr>
<tr>
<td>1985</td>
<td>46.87</td>
</tr>
<tr>
<td>1986</td>
<td>53.54</td>
</tr>
<tr>
<td>1987</td>
<td>58.32</td>
</tr>
</tbody>
</table>

New collaborators take the opportunity to place their claim on the equity by providing finances in the form of capital goods. Thereby they find entry into the ownership and management of the Indian enterprises. It needs to be mentioned that one of the objects of inviting foreign financial participation is to combat the foreign exchange bottleneck arising out of adverse balance of payment position.
The registered quantitative increment of foreign participation mainly by the method of ploughing back of profit may provide temporary relief to the problem in the short run due to the postponement of current remittance of the foreign partner's share of profit but it causes doubt whether and how far it is effective in the long run particularly when the insignificant fresh inflow of capital from the foreign participant is tied up with uneconomic import of goods at higher prices. It requires special mention that all these happened mainly before the introduction of the Foreign Exchange Regulation Act in 1973. We have kept loan capital outside the scope of our study (as discussed in Chapter 3). We may now concentrate our delineation on the aspect of participation in share capital by the foreigners.

**Participation in Share Capital**

Of the two forms of shares viz., Preference and Equity, the foreigners generally prefer participation in equity shares. The Government's policy in India was normally to allow the minority foreign participation upto a limit of 40 per cent and to consider the majority participation in exceptional circumstances like high-technology areas and export-oriented industries. But the foreign investors are tactical enough to manage the dilution of ownership-mix in a way that has not caused any significant diminution of foreign control. Again, as the Government have been allowing foreign equity holding to the extent

it covers the foreign exchange cost of the project, foreign collaborators have been following the practice of keeping the equity-base of the joint venture relatively small, so that their contribution to total equity ensures at least effective control if not normal majority-ownership. In effect, therefore, foreign control has prevailed in a large number of foreign collaborations.

In the public sector too, foreign equity participation exists though in minor proportion as compared to the foreign technical collaboration. Of the 41 government companies covered by the survey undertaken by the RBI, there were only 9 companies with capital participation, of which 7 companies had package form of collaboration while the remaining two companies, which were earlier in the private sector, had only foreign capital participation.

The Government's overall policy towards investment by foreigners, particularly by non-resident Indians (NRIs), had been to encourage such investments on the consideration that they could make a valuable contribution to the economy in terms of inflows of foreign exchange. With the intention of promoting such investment flows, the regulations

18. K.K. Subrahmanian, Import of Capital and Technology, Peoples' Publishing House, New Delhi, 1972, Ch. V.
* Public Sector companies have been defined in the RBI Survey Report as the companies in which the Government is a majority participant in equity capital.
governing investment by non-residents had been liberalized. The Government announced a new scheme of portfolio investment for non-resident Indians in the Budget for 1983-84. The tax rates applicable to incomes from such investments were also rationalized. But such investment by foreigners was not left unattended. In fact, certain restrictions were imposed on the investment by foreigners by the introduction of the Foreign Exchange Regulation Act (FERA) 1973. According to sub-sections (1) and (5) of Section 19 of the said Act,

"notwithstanding anything contained in Sec. 81 of the Companies Act, 1956, no person shall, except with the general or special permission of the Reserve Bank, issue, whether in India or elsewhere, any security which is registered or to be registered in India, to a person resident outside India, .... Notwithstanding anything contained in any other law, no transfer of any share of a company registered in India made by a person resident outside India or by a national of a foreign state to another person whether resident in India or outside India shall be valid unless such transfer is confirmed by the Reserve Bank on an application made to it in this behalf by the transferer or the transferee."

Section 81 of the Companies Act, 1956, as referred to above, provides for offering further issue of shares to the persons who, at the date of the offer, are holders of the equity shares of the company, in proportion, as nearly as circumstances admit, to the capital paid up on those shares at that
So, this section of the FERA provides for the permission of the Reserve Bank of India (RBI) to transfer or to issue any security in favour of the foreigners. In effect, the Reserve Bank may not give permission to any such transfer of shares if it is considered prejudicial to the interest of the general public or of the company. Sub-Section (1) (B) of Section 29 of the said Act provides that:

"... a person resident outside India (whether a citizen of India or not) or a person who is not a citizen of India but is resident in India, or a company (other than a banking company) which is not incorporated under any law in force in India or in which the non-resident interest is more than forty per cent or any branch of such company, shall not, except with the general or special permission of the Reserve Bank, ... acquire the whole or any part of any undertaking in India of any person or company carrying on any trade, commerce or industry and purchase the shares in India of any such company."

Therefore, Section 29(1) (B) of the FERA is mandatory. No NRI investor is authorized to purchase shares in an Indian company without prior permission of the RBI under Section 29 (1) (B) of the FERA.

The liberalized portfolio investment scheme contained in the Central Budget for 1983-84 created apprehension of speculative take-over bids of established companies by NRIs
by misusing the liberalized scheme. Because under this
scheme NRIs were allowed to undertake portfolio investment
without prior specific approval of the RBI under the FBRA.
This permission to an investor was without limit in the
case of non-repatriable investment and with a limit of 1/
per cent of paid-up equity capital in the case of repatria-
table investment. With a view to preventing the apprehended
misuse of the scheme the Government of India resorted to
the imposition of an overall ceiling of 5 per cent on the
total NRI holding of the paid-up equity capital of well-
established public limited companies in India. Prior permi-
sion of the RBI is essential for the total NRI holding
exceeding the limit of 5 per cent. The Government issued
instructions also to the public financial institutions, who
had significant shareholdings in many important companies,
ranging between 25 per cent and 50 per cent, to use their
voting power to prevent any threatened take-over of well-
managed companies by NRIs through their buying of equity
shares. The scheme was subsequently modified and the NRIs
were allowed to purchase equity shares and convertible
debentures on repatriation basis without the Reserve Bank's
specific approval for each transaction, to the extent of 1/
per cent of the equity capital of the company or 1 per cent
of the total paid-up value of convertible debentures in
each series issued by the company, per non-resident inves-
tors. Such purchases would, however, be subject to the
overall ceiling of (A) 5 per cent of the total paid-up
equity capital of the company concerned and (B) 5 per cent
of the total paid-up value of each series of the convertible
debentures, as the case may be. Furthermore, the original portfolio investment scheme provided that the NRI investor, if it were to be a company, firm, society or trust and not an individual, was eligible to make investment under the scheme only if non-residents of Indian nationality/orign held ownership or beneficial interest therein upto 60 per cent or upwards. If such interest was held indirectly they were not eligible to get permission under the FSRA. The Government subsequently made clarification to this clause to the effect that the permission to purchase shares in Indian companies may be granted to even entities in which non-residents of Indian nationality held ownership or beneficial interest, even indirectly, upto or above 60 per cent. This clarification, according to the decision of the Bombay High Court in the case of Escorts Ltd., amounts to amendment and is effective only prospectively.

What has been described above is that unrestricted investment by foreigners including the NRIs is not


* In this case the Caparo group of 13 companies, controlled by Mr. Swraj Paul as Chairman of the group, purchased 20 lakhs shares of the Escorts Ltd., without obtaining prior permission of the Reserve Bank of India. But on the date of purchase the non-resident Indians did not directly hold 60 per cent or more shares in the group of companies so as to make them eligible for purchasing shares under the portfolio investment scheme. The management of the Escorts Ltd. refused to transfer 4.67 lakh shares bought by Caparo Group. It was held by the Bombay High Court that the Escorts Ltd. was right in refusing to transfer the shares.
desirable since it may create problems like threatened takeover by the foreigners, concentration of power in the hands of the foreigners, etc. That is why, the Government was to intervene and impose restrictions through the provisions of the FERA and the Monopolies and Restrictive Trade Practices (MRTP) Act, 1969. It needs mention that with a view to preventing the concentration of economic power the MRTP Act provides for the imposition of restriction on the acquisition and transfer of shares of certain bodies corporate by both foreigners and Indians. This can be evident from the provisions of the following sections of the MRTP Act.

According to Section 30B:

"(1) Except with the previous approval of the Central Government, no individual, firm, group, constituent of a group, body corporate or bodies corporate under the same management, shall jointly or severally acquire or agree to acquire, whether in his or its own name or in the name of any other person, any equity shares in a public company, or a private company which is a subsidiary of a public company, if the total nominal value of the equity shares intended to be so acquired exceeds, or would, together with the total nominal value of any equity shares already held in the company by such individual, firm, group, constituent of a group, body corporate or bodies corporate under the same management, exceed twenty-five per cent of the paid-up equity share capital of such company."
(2) Where any individual, firm, group, constituent of a group, body corporate or bodies corporate under the same management ... is prohibited, by sub-section (1) from acquiring or agreeing to acquire except with the previous approval of the Central Government, any share of a public company or a private company which is a subsidiary of a public company, no -

(a) company in which not less than fifty-one per cent of the share capital is held by the Central Government; or

(b) corporation (not being a company) established by or under any Central Act; or

(c) financial institution,

shall transfer or agree to transfer any share to such acquirer unless such acquirer has obtained the previous approval of the Central Government for the acquisition or agreement for the acquisition, of such share.

Section 30C provides for the imposition of restriction on transfer of shares as follows:-

"(1) Every body corporate, or bodies corporate under the same management, holding, whether singly or in the aggregate, ten per cent or more of the nominal value of the subscribed equity share capital of any other company, shall, before transferring one or more of such shares, give to the Central Govern-
merit an intimation of its or their proposal to transfer such share...

(2) Where, on receipt of an intimation given under sub-section (1) or otherwise, the Central Government is satisfied that as a result of such transfer, a change in the composition of the Board of directors of the company is likely to take place and that such change would be prejudicial to the interests of the company or to the public interest, it may by order, direct that -

(a) no such share shall be transferred to the proposed transferee. ...."*

We have discussed earlier a few aspects of foreign participation with particular reference to legal provisions contained in various statutes of the country. We now touch upon several problems that may arise owing to foreign participation specific to the inflationary situations in the following paragraphs.

Rights and Liabilities of Shareholders

Shareholders of enterprises enjoy certain rights attached to their shareholdings. In limited liability companies (liabilities of shareholders are limited by the amount of their investments in shares), these rights are mainly the right to receive dividend and the right to the share capital, in addition to the voting right. These rights are too much sensitive to the existence of share capital. That is, they disappear with the disappearance
it has been described earlier (Chapter 3) that under historic cost accounting gradual erosion of capital in times of continuous rise in price levels may culminate into a situation when a significant portion of the share capital or even the entire share capital in real terms may be paid out as dividend with or without the knowledge of the management of the enterprise or of the shareholders. But still they may remain the shareholders and consequently may continue to enjoy all the rights attached to the shareholdings since their nominal capital has been kept intact. Practically, since then they get dividend without any real investment. Not only that, but they also preserve their right to withdraw the nominal capital even after receiving back the entire amount of share capital in real terms by way of dividend out of inflated profit. On the other hand, as to their liabilities as shareholders, they continue to remain liable for any loss of the enterprise to the extent of their respective nominal capital.

Outflow of Foreign Capital

It has been described earlier that one of the objects of inviting foreigners to subscribe in the share capital of Indian enterprises is to invite foreign capital into the country for its industrialisation. But because of gradual erosion of capital it is difficult to achieve this objective. In other words, in times of continuous inflation payment of dividend may be made out of capital if conventional or historic cost accounting is followed. Even dividend may be
continued to be paid after paying out the entire real capital by way of dividends. As a whole, for each share of foreign shareholders the total outflow of foreign capital may exceed the total inflow resulting in a net outflow of foreign capital from the country arising out of foreign participation in share capital. From the point of view of the enterprise the outflow of capital (not necessarily the foreign capital) may also happen even if there be no foreign participation. But that outflow is not the outflow from the country. The wealth involved in the process of outflow, being a portion of capital in the form of dividend, remains within the country in some other form at the disposal of some other individual within the nation. Naturally the wealth involved is not supposed to lose the character of national wealth. What happens is that some individuals of the nation are being benefited at the cost of the enterprise within the same nation. So, it may be termed as redistribution of wealth within the nation. But similar is not the case of foreign participation. In such cases the party benefited is a foreign national while the losing enterprise is indigenous. So from the point of view of the nation as a whole the country is supposed to lose its wealth to the benefit of the foreigners. Consequently, the ultimate objective of attracting foreign capital will go in vain; instead, there may arise a continuous outflow of foreign capital during the period of a continuous inflation.