



Identifying and Mitigating Third-Party Counterparty Risk in India

Compliance and Ethics



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Highlights:

- Before doing business with an entity in India, conduct adequate due diligence into their compliance profile and other risks.
- Lack of adequate due diligence into a new Indian counterparty may result in serious reputational harm.
- There are external sources that can be used to assess certain risks pertaining to an Indian entity.

India has emerged as a preferred destination for doing business due to aspects such as its rapid growth, focus on facilitating business, cost competitiveness, and a stable political environment. However, cross-border transactions sometimes involve counterparty risks, which makes it important to adopt appropriate mitigation strategies to preserve the interests of a foreign party.

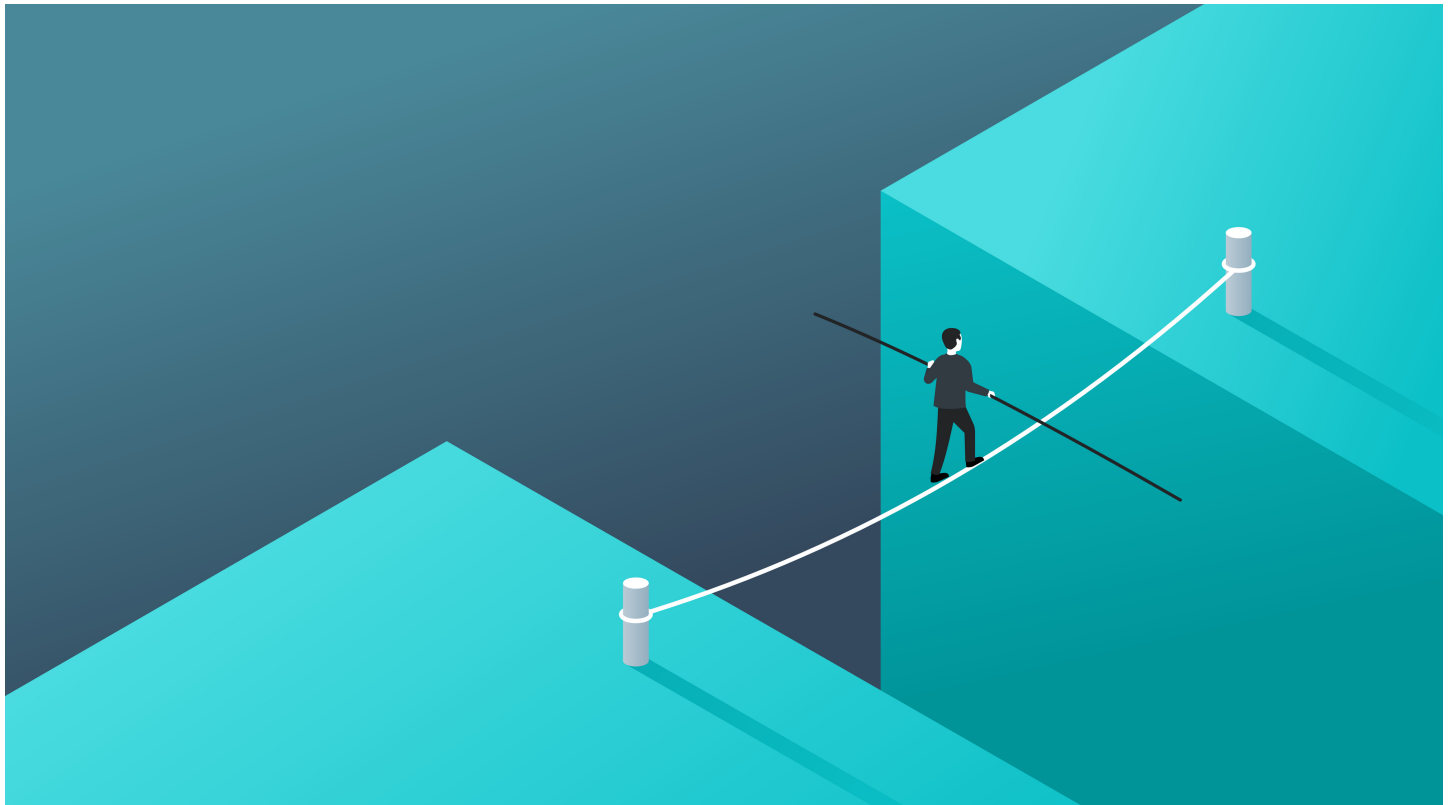
Below are key counterparty risks for a foreign party, while engaging in a commercial transaction with

an Indian party, and effective strategies which can be adopted to mitigate such risks ahead of a transaction.

Key counterparty risks

Compliance risks

Indian companies sometimes struggle with ensuring compliance with various Indian laws due to unawareness of laws, or lack of expertise, checks and balances or requisite tools to track compliance and changes in law. Non-compliance with anti-corruption and anti-bribery laws is one of the most prevalent risks while doing business in India. Similarly, adherence to intellectual property, data privacy, environmental and employment laws remains poor due to weak enforcement.



Success isn't risk-free. It's risk managed.

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Financial risks

The global economic situation is impacted by various factors such as the COVID-19 pandemic, geopolitical or trade conflicts, and inflation. Often, developing nations such as India are hit worse in such scenarios. This influences the financial stability of domestic businesses, resulting in payment defaults, cash flow concerns, and compromised ability to deal with currency risks.

Cultural risks

India has a unique and diverse cultural and social environment that can pose challenges for foreign businesses, particularly in areas such as communication, negotiation, relationship-building, and adapting to local customs and etiquettes. For instance, hierarchy, which is unavoidable in Indian

culture, shapes team dynamics and impacts the efficiency and speed of business interactions. In addition, Indians tend to communicate diplomatically or indirectly, which foreign entities may find to be starkly different from the direct manner of communication that they are familiar with.

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Reputational risks

Reputational damage in the form of negative publicity, loss of customer trust, and harm to brand image is a reality in India, given past instances of corruption, bribery, corporate fraud, and actions by the [Enforcement Directorate](#) (i.e., an organization in India mandated with investigation of money laundering offences and violations of foreign exchange laws) or [Serious Fraud Investigation Office](#) (i.e., an organization in India mandated with investigation and prosecution of complex corporate frauds). Other issues that may be detrimental to reputation are engaging with entities having operations in sanctioned countries, inappropriate political support and links to politically exposed entities, unethical business practices, links with willful defaulters declared by the Reserve Bank of India (i.e., the central bank of India — RBI).

Operational risks

Sometimes, Indian parties tend to not pay adequate attention to internal infrastructure, processes, and systems, which may lead to business continuity issues such as supply chain disruptions and inferior quality of products or services.

Dispute-related risks

With India being considered as supportive of doing business, the number of commercial disputes between foreign parties and their Indian business partners has increased. While alternative dispute resolution mechanisms have become more accepted, foreign entities must be aware that litigation in Indian courts remains a long drawn, tedious, and costly affair.

Other legal and regulatory risks

The Indian federal system leads to an extensive set of various laws which may become difficult to navigate. This may render a foreign party susceptible to being roped into schemes or loopholes, which may well be a result of lack of awareness of laws by the Indian party.



In the maze of business, perceiving risk is the first step towards the exit. Artwork by Dmitry Kovalchuk / Shutterstock.com

Mitigation strategies

It is critical to develop a risk management policy and mitigation strategy commensurate with the local risks of the proposed transaction. Such an approach should be modified from time-to-time to adapt to the evolving commercial environment. In-house counsel should focus on the following.

Due diligence

Prior to engaging in a formal arrangement, investigate the prospective business partner to uncover any red flags. Below are key tips for conducting effective diligence:

- Engage a due-diligence specialist: Depending upon the significance of the business relationship, foreign entities may engage a local due-diligence expert to conduct the diligence. This would make the process more efficient, as the local advisor would be accustomed to Indian laws and practices.
- Maintain a central repository: Large multinationals often work with the same business partners in a particular jurisdiction. Having an internal system for consolidating third-party information is beneficial, as it facilitates faster internal screening and provides trusted feedback on a third-party from within the corporate group.
- Formulate onboarding policies: Formulate policies setting out eligibility criteria, a code of conduct, and ethics and operational guidelines that any third-party is expected to follow prior to being onboarded. This would provide a useful guideline for conducting an initial diligence on the third-party.

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- Conduct initial diligence: As part of the initial diligence, focus on collecting all requisite third-party information as may be detailed in the onboarding policies. This would include documents evidencing legal and financial status such as charter documents and bank statements, tax information such as tax returns and licenses, business approvals relating to the core-business, and expertise of the third-party's team.
- Use external information: To undertake a complete assessment of the risks, it is crucial to validate the results of the initial diligence with information received from external sources.
 - The legal status of an entity can be verified through publicly available information on the [website](#) of the Indian Ministry of Corporate Affairs (MCA Information). The MCA Information includes a snapshot of details such as legal name, date of incorporation, registered office address, names of directors, etc. In addition, on payment of a nominal amount, you can access various regulatory filings made by the entity such as relating to shareholders, annual returns, and financial statements.
 - The financial status of an entity, along with its credit worthiness, can be authenticated from its financial statements (including any adverse comments by the auditors in such statements) and collaterals offered against loans based on MCA Information, defaulter watchlists published on the [website](#) of the RBI, and credit scores issued by credit rating agencies.
 - Background checks and referrals may aid in corroborating experience and track record to ensure that the team possesses the requisite capabilities to fulfil its commitments. They also help evaluate if the third-party has a history of poor performance, litigiousness, or fraud.
 - Global watchlists and media reports may also be referred to check if the third-party poses any reputational issues.
 - While India does not have any central archive wherein all pending litigations involving an Indian party can be uncovered, appropriate searches can be conducted on the websites of the [Supreme Court](#) (i.e., the apex court in India) and select High Courts (i.e., highest court in the federal units in India) for a certain level of comfort.
 - With advancement in technological tools, various software are now available that automate basic diligences and provide instant reports setting out an overview of the compliance status under the major Indian legislations. Further, various technological solutions are also available to help in culling out the legal framework that may be applicable to a specific transaction.

Ongoing monitoring

Diligence does not end with the onboarding process since it is crucial to ensure ongoing compliance by the third-party. For this purpose, adequate systems and practices must be put in place to implement periodic assessments, documentation updates, and regular reporting. Effective resource management must also be done internally to demarcate roles and responsibilities of overseeing and managing the third-party and its relationship with your entity.

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Engaging local experts

Assess the need to engage local experts, depending on the risk appetite of the foreign entity. For instance, a local legal advisor could assist in drafting or vetting contracts to:

- Safeguard its client from vaguely worded roles and responsibilities;
- Draw up appropriate dispute resolution clauses;
- Ensure compliance with local laws and practices with adequate practical remedies in case of breach; and
- Suggest contractual clauses to safeguard against identified risks concerning the counterparty.

In addition, engaging a local legal advisor would be prudent to navigate through the numerous Indian legal requirements that regulate the relevant transaction, and to ensure compliance with such requirements by the foreign entity itself and its Indian business associate.

Similarly, advisors may assist in conducting trainings and workshops to educate the foreign party's personnel about the varied cultural factors that may impact the transaction while dealing with Indian parties.

Contingency plan

Despite careful planning, various factors, both at macro and micro levels, may hamper domestic businesses in India which, in turn, may create counterparty risks for foreign entities. To reduce the impact of unexpected events, businesses should have a contingency plan in place. This plan should include last resort measures for taking appropriate corrective and preventative measures. For instance, contracts should have adequate flexibility for termination for convenience and specified circumstances such as bankruptcy or adverse regulatory action.

A strategic imperative

A cross-border transaction between two parties is influenced by many factors, some of which manifest as risks for a foreign party that is engaging with an Indian party. Pre-empt risks involved in such transactions and effectuate appropriate mitigation strategies by inculcating a robust third-party

diligence program.

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