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Private Equity Investment:
Significant Aspects of Corporate Laws

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The Private Equity International, 2011 issue, reveals that the world's 50 largest private equity direct investment programs have raised in excess of US$325 billion since 2006. In line with the global trend, private equity (PE) investments in India is also getting popular and is an increasingly important source of funding now-a-days. PE investments into India have risen by around 22 per cent in 2011 till date over the corresponding period of last year, to $7,160 million (Rs 32,220 crore), and the number of deals rose by around nine per cent. According to data compiled by Venture Intelligence, from January to August (till date), PE firms had invested this amount across 246 deals, compared to $5,831 mn (Rs 26,235 crore), across 226 deals in the same period in 2010.

A report titled **India Private Equity Report 2011 by Bain & Co** stated,

> "The fundamentals look auspicious for PE in India to continue to grow and evolve in 2011 and beyond. Short-term nervousness in the capital markets in 2011 and high-priced corporate debt are expected to keep valuations down. That is likely to help open interesting deal-making opportunities."

Now the question is what is PE and how does the whole network works?

Private equity investment, as the name suggests, is investment in equity or in equivalent securities of a company (generally called the 'target company') privately. Private equity is the provision of equity capital after a negotiation process between the investor and the target company and its management over a medium or long term, generally to non-quoted target companies with high growth potential. The PE investments are of medium to long term nature aimed at not purely investing but also nurturing the companies in terms of provision of management and operational support in a few cases to see to it that the return on these investments grow and expand in the medium and long term. The players of PE can be the big PE funds, institutional investors registered with SEBI or the

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PE agreement can be entered into between the target company and either a single or a group of small investors who are interested in return from the investments. PE agreements are identical to a joint venture agreement except that a PE investor is a passive investor looking for an exit at an appropriate time, so the former is more exit-focused.

Different forms of PE

Among the most common investment strategies in private equity are:

- **Leveraged Buyouts:** Leveraged buyout, LBO or Buyout refers to a strategy of making equity investments as part of a transaction in which a company, business unit or business assets is acquired from the current shareholders typically with the use of financial leverage. The companies involved in these transactions are typically mature and generate operating cash flows
- **Venture Capital:** Venture capital is a broad subcategory of private equity that refers to equity investments made, typically in less mature companies, for the launch, early development, or expansion of a business. Venture investment is most often found in the application of new technology, new marketing concepts and new products that have yet to be proven.
- **Growth capital:** Growth Capital refers to equity investments, most often minority investments, in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets or finance a major acquisition without a change of control of the business

What is a PE Agreement and how does it look like?

In any of the above type of equity investment, an agreement is entered into between the investors, the founder promoters and the target company in which the investment is to be made so that the role, scope and responsibilities of each of

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the party may be defined. Such an agreement is commonly referred to as "Private Equity Shareholders Agreement" or "Venture Capital Investment Agreement". Such agreements are generally drafted favouring the investors as

- The investors trust the target company and its management with their money
- The management of the company has control over the day to day functioning of the company and hence some degree of control is required for avoiding misuse of investors money
- To protect the interest of the investors who generally are minority shareholders in the target company

Ways of making investment

Instruments used for investments are:

- **Equity Shares:** These are the ordinary equity shares held by the promoters of the company. When investor subscribes to the equity shares, his shares are exactly like the existing shares of the company and have no special rights on assets or earnings of the company. In case the company was to go bankrupt, the common shareholders are paid after debt holders, preferred shareholders and other creditors of the company.

- **Compulsorily convertible preference shares:** These are the shares on which special rights on assets and earnings of the company are given. They get preference of dividend and other payments.

- **Compulsorily convertible debentures (CCD):** These are the instruments, which start out as debt (with a fixed interest) and can be converted into equity (or any other form of security) at an agreed-upon time and price.

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Investors generally prefer to make investment using both of the above convertible instruments as they provide preference at the time of liquidation, preferred dividend rights and enable the investor to enforce anti-dilution rights.

Valuation of the target company

Valuation of the target company is done for the purpose of determining the no. of equity shares to be issued/ no. of equity shares that the convertible securities convert to when preference shares or debentures are issued to the investors.
Valuation may be:

- pre-money valuation i.e. the value of the Target as agreed to between the Investor and the Target for the purposes of the transaction, or
- post-money valuation i.e. pre-money valuation of the Target plus the amount of money that the investor invests.
- Ratchets: where the Investors and Founders are unable to agree upon the valuation, the determination of the valuation is postponed to a subsequent point of time. Typically this occurs because the Investor does not agree with the projections that are presented by the Target. In these situations the valuation is determined based on the actual performance of the Target during the agreed period

Typical clauses and issues in a PE Shareholders Agreement (PE SHA)

The clauses, rights of investors and of promoters in a PE SHA depend on the power of negotiation of each of the party. Apart from the general clauses as included in a Shareholders Agreement[1]in case of a joint venture, a PE SHA specifically includes:

[1] http://india-financing.com/staffpublications_jv.htm

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- **Representation and warranties**

  It is an important aspect of a PE SHA as the investor, relying on the representations and warranties by the target company and its management, takes a decision of investment.

  Representations are made relating to the business, financial position and operation of the target company. On the basis of these representations only, an investor comes to know whether:

  - the company is in compliance with law,
  - the financial position of the company is as presented to the Investors,
  - the assets of the company are unencumbered,
  - the company is not subject to any pending or threatened litigation or third party claims,
  - the company or the promoters do not have any non-compete obligations that could affect the company's business,
  - the company is not in breach of any law,
  - the company has full ownership of all intellectual property rights that it claims and that it is not infringing any third party intellectual property rights, etc.

- **Clauses relating to Investors rights and protection**

  - **Liquidity preference:** Liquidation Preference implies the preference given to the investor at the time of liquidation event (such as merger, liquidation, dissolution, acquisition or series of events in which the company's existing shareholders will lose their control over the company) of the company. It means the investor

will be given preference on the liquidation proceeds of the company over other common shareholders. While drafting this clause, one should carefully define the 'liquidation event' as liquidation preference will get triggered in case any liquidation event happens. On occurrence of a liquidity event, investors get preference in any of the following agreed manner at the time of occurrence of such events:

- capital protection, i.e. Investors receive the higher of their pro-rata share based on the shareholding or the amount they have invested,
- a double dip where the Investors first receive the amount they have invested and the surplus is distributed amongst all shareholders (including the Investor) based on the pro-rata shareholding,
- the investors receive the higher of the amount of capital invested with a return at an agreed rate or their pro-rata entitlement based on their shareholding

- **Anti-Dilution Protection:** This safeguard is available for the investors who are investing in company's equity, obviously after the mutual consensus of the parties involved and as the name suggests, it protects the investors from any dilution of their investment at the time of further investment by other investees or further issue of shares by the company at a higher price than the price at which the shares were issued to the investors. The investors, if protected with such a right, can have:

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- The price of shares that he has paid adjusted downwards up to the same price at which the new issuance has been made. For example; if the investor has purchased the shares at say Rs. 100/- per share and the new issue price is Rs. 50/- per share, then his price per share shall also be reduced to Rs. 50/- per share.

- price per share reduced based on the weighted average price of the new issuance taking into consideration only the preferred shares in respect of which the anti-dilution protection is available in the agreement

- price per share reduced based on the weighted average price of the new issuance and the pre-issue capital taking into consideration that all the convertible securities have been converted into equity.

Generally, the first option as described herein above is preferred by the investors whereby his price gets adjusted at par with the new issue price. However, these anti dilution protection may not be available in case of issue of securities to the employees of the company, or to the investor approved strategic partners of the company, or in case where the investors have capital pattern maintenance right.

- **Right to maintain capital ratio:** In such a protection, the investors are given a right to maintain their pattern and percentage in the share capital if the company comes with a new issue. Here, the investors will enjoy the same rights and privileges as the other shareholders and will not have any preference.

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- **Drag-Along Rights:** In a 'drag along' or 'bring along' right, the investor is given the right to drag along the other shareholders when they initiate a sale of their shares in the company and are generally exercisable when the company and its management do not give the investor a viable exit option. Drag Along rights are usually a *sine qua non* for any investment. It is becoming increasingly important to incorporate such right in the agreement. If structured and implemented properly, they can provide important protection for the private equity firm when it is time to exit portfolio company investments. Some private equity investors affectionately refer to their Drag Along rights as their "nuclear option." On the other hand, for many business owners, a Drag Along right represents a Damocles sword, a threat that they may be forced to sell their business if the investor decides to drag him or her along, usually at a valuation over which he or she has no control.

  However, a drag along right is more controversial than a tag along right as it gives the investing shareholder the right to force the other investor(s) to exit usually on the same price and terms.

  The Delaware Supreme Court nullified the deal protection terms of a negotiated merger transaction in *Omnicare, Inc. vs. NCS Healthcare, Inc.* [818 A.2d 914 (Del. 2003)] In this case, the Court invalidated a combination of deal protection terms, including (1) an irrevocable agreement among the holders of 65% of the target's outstanding stock to vote in favor of the deal; (2) an agreement to put the merger to a vote of the target's shareholders even if the board of directors withdrew its recommendation of the deal; and (3) the lack

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of an effective "fiduciary out." The Court determined that this combination of defensive measures precluded the ability of the directors to exercise their fiduciary duties, and of shareholders to reject the transaction.

In *Minnesota Invco of RSA #7, Inc. v. Midwest Wireless Holdings LLC,* [2006 WL 1596675], the Court of Chancery upheld Drag Along Rights. The court held that the minority owners had lost their rights to block the sale of the holding company by virtue of the reorganization agreements executed when the holding company was formed. Further, the Court held that the minority investors could be "dragged along" to sell their interests in the LLC over their objections because the reorganization agreements superseded their rights as minority owners. The lesson is that a party needs to be careful to protect its existing contract rights when entering into any new agreement that may affect those rights in a less than clear manner.

- **Tag-Along Rights:** On the other hand, a tag along or co-sale right is a right that enables the investor to participate in a sale of shares by the majority shareholder on the same terms as available for the majority. Typically this is a right to participate on a pro-rata basis. This enables the investor to seek an exit if they are not comfortable with the buyer controlling the target company.
- **Right of first refusal (ROFR):** It is a right that provides to the investor a right to first refuse any shares that the promoter/founders of the company wish to transfer on the same terms as are agreed to between the promoters and any third party buyer. For example, if in a company, investor has the RoFR and the

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company's promoters are planning to sell their stake to a third-party at a certain price, then they will first have to ask the investor if he is interested in buying that stake. Once the investor has made his mind on either buying the promoter's stake or refusing to buy it only then promoters can sell it to the third-party. A typical situation in which investors evoke this right is when the company is looking for next round of funding. In such case, if the company has found a new investor at certain terms and conditions then current investors can use their RoFR to invest more in the company, as they would have first right of refusal on the equity company is selling. In the same way, if an investor who is planning to exit the company, is obliged to give the promoters an opportunity to buy the shares before the shares can be sold to a third party.

Though this right is present in many investment and joint venture agreements, this is the topic of much discussion as for some; it is to hamper the free transferability of shares and in violation of section 111A of the Companies Act, 1956. There are series of rulings that says that any restriction on transferability of shares is in violation of Section 111A of the Act and did not enforce the pre-emptive rights of the shareholders of a company as the same were not incorporated Articles of association of the company. Some of these are: *V.B. Rangaraj v. V.B. Gopalakrishnan* (AIR 1992 SC 453), *Mafatlal Industries Ltd., v. Gujarat Gas Co. Ltd* (97 Comp Cas 301 Guj), *Pushpa Katoch v. Manu Maharani Hotels Limited* ([2006] 131 Comp Cas 42 (Delhi)], *Western Maharashtra Development Corporation Ltd. Vs. Bajaj Auto Ltd* [(2010) 154 Company Cases 593 (Bom)].

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On the other hand, the Supreme Court in 2003 in its decision in *M.S. Madhusoodhanan v. Kerala Kaumudi Pvt. Ltd.* (2003 117 CompCas 19 SC) not disagreeing with the decision in V.B Rangaraj (Supra) but distinguishing itself from the facts in that judgment, held that a restriction in relation to identified members on identified shares of a private company did not amount to restriction of transferability of shares per se. Recently also, the Division Bench of Bombay High Court in *Messer Holdings Limited v Shyam Madanmohan Ruia and Ors* [(2010) 98 CLA 325] overruling its own previous decision in Western Maharashtra Development Corporation Ltd (Supra) held that any private arrangement in relation to shares are not in violation of section 111A of the Act. The Bench, analyzing inter-alia the validity of ROFR, giving liberal meaning to the term 'transferability', held that Section 111A of the Act is not a law dealing with the right of the shareholders and does not expressly restrict or take away the right of shareholders to enter into consensual arrangement/agreement by way of pledge, preemption/sale or otherwise. The expression freely transferable in Section 111A of the Act does not mean that the shareholder cannot enter into consensual arrangements/agreement with the third party (proposed transferee) in relation to his specific shares.

ROFRs, if reasonable, have been held as valid and enforceable under the Delaware and New York Laws also (*Martin v. Graybar Elec. Co.*, 285 F.2d 619, 625*)*. The same concept may also be applied to the tag along/drag along rights in an agreement as these are also restrictive rights on shares of the company.

- **Strategic Sale rights:** Under a strategic sale right or popularly known as a 'put option' in a PE SHA, investors are given an irrevocable strategic sale right, being rights exercisable by the

investors at their sole discretion upon the non-occurrence/occurrence of any of the event as may be decided mutually in the PE SHA at an agreed price. This right has not been provided to an investor under any law but is a result of the contractual relationship between the investor and the company. Hence, this right is available only if specifically incorporated in the agreement.

A 'put option' provides an option to the investor to sell its shares the performance of which is to be done in future on happening of certain event. Such contacts are forward contracts and legality of which may be questioned. All such contracts are governed by SCRA and since, the Act does not apply to private companies, a private company can enter into such forward transactions.

- **Information rights:** Specific clauses may be added in a PE SHA to allow the investor to inspect the books and records of the company as and when required and to be provided with periodical financial statements from time to time.

- **Exit right:** This is one of the most important right available to an investor and is present in every PE SHA as the investors are financial investors and they need to make an exit from the investment at some point. They, therefore, negotiate appropriate rights that give them the appropriate exit opportunity. Depending on case to case basis, the exit right may be availed in any of the following event as agreed upon between the parties:

    - listing of the securities,

- sale of securities held by the investor,
- commitment of company to buy-back the securities held by the investor,
- commitment by the promoters/other majority shareholders to buy-back the securities held by the investor
- negotiating put option on the promoters/majority shareholders if other exits are not provided

Among the above, listing of the securities held by the Investor, sale of the securities and a promoter buy-back are not guaranteed and failure to provide such exits do not constitute a breach. In general, investors prefer an exit option by company buy back option as it is subject to the sufficient cash with the company and buy-back regulations being satisfied.

- ***Provisions relating to company governance***
  - **Transfer provisions**
    - **Transfer by promoters:** Sufficient provisions must be drawn in the agreement to restrict the transfer of shares by the promoters of the company or permitted transfers may be allowed after the approval of the investor and as specifically mentioned in the PE SHA.
    - **Transfer by investors:** Terms and conditions relating to transfer of shares by the investor after the exit or prior to exit must also be clearly identified in the agreement.

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- **Maintenance of control in Board and General Meetings**

  - **Constitution and Regulation of Board and Board proceedings:** Some Investors seek Board representation without any more rights while some Investors like to see a balanced board structure having either an independent director or a representation of the investor on the Board. The constitution of Board depends on the mutual agreement terms and the investor must ensure that the Board is duly constituted as per the agreement. Apart from the structure of the Board, provisions relating to quorum, notice of meetings, length of notice of meetings, circular resolutions, appointment of alternate directors etc., are also to be carefully drafted. Apart from the right to nominate members on the Board, investors normally negotiate a right that their approval is to be procured for a list of items that they consider "significant decisions". Essentially this means that the company needs the affirmative approval of the investor in respect of these significant decisions affecting the interest of the investors and hence, should be clearly drawn out in the agreement. Since corporate decisions may be taken using the methodology prescribed in corporate laws, it is important to ensure that certain matters that may have an impact on the interests of investors are not decided without the consent of the investor. The list of such reserved matters must be carefully drawn – it should be not too restrictive so that the business of the company may be deadlocked on

petty issues; at the same time, it must fully protect the interest of the investors.

- **Shareholders meetings:** The agreement must contain the provisions relating to voting in general meeting also. It is important to ensure that no decision affecting the rights of investors are passed in a general meeting without the consent of the investor.
- **Voting rights:** That voting power in the target company shall always be held in the proportion decided in the PE SHA, and that no action, whether by issue of capital, or by issue of any other contingent capital instrument, the balance of voting power in the target company will be disturbed.

- ***Rights of the promoters and the company***

The promoters may also negotiate for their rights and terms which may include:

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- **Sale to competitor:** Notwithstanding the rights given to the investors in a PE SHA, a promoter may negotiate for an undertaking from the investor that the investor shall not sell his shareholding to any of the competitor of the company during an agreed duration.

- **Right of refusal:** This may be included in case the investor proposes to sell his shares in the company to an outsider. Under this right, the investor shall be giving the first offer for sale of shares to the promoters and on their refusal, to outsiders.

- ***Dispute resolution and arbitration clause:***

This is a significant clause since corporate litigation may be very costly and it may be helpful to seek alternative dispute resolution devices.