THE (UN?)ENFORCEABILITY OF INVESTOR RIGHTS IN INDIAN PRIVATE EQUITY

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ABSTRACT

While Private Equity ("PE") funding is a preferred vehicle for corporate growth in India, due to the ubiquitous role played by company promoters, extant laws, and a complex regulatory and compliance environment, PE funds prefer to take up a minority shareholding in Indian companies. As a result, PE funds invest in Indian companies in exchange for participation in the company's profits either through equity or convertible preferred stock or convertible debt. The PE fund typically also requires a number of investor control rights to be negotiated as part of the investment, keeping in mind concerns related to minority shareholding in India.

While these contractual rights typically do not interfere with the day-to-day management of the company, they serve as a check and balance against promoter opportunism. These rights include provisioning for the investor to participate in the governance of the company through board nomination, quorum requirements and veto powers. Investors may also require downside protection in the form of anti-dilution and pre-emptive exit rights and preferred payments upon liquidation.

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However, the nature of these investor control rights is a departure from the default provisions under Indian company law. These rights, which are borne out of a contractual arrangement between the investor and the company/promoters, are also subject to Indian contract law, under which contracts in variation of applicable law are void. Additionally, due to excessive delays in the Indian judiciary, any disputes that may arise are not referred to the courts but are privately arbitrated or settled. Consequently, the enforceability of these contracted rights has never been tested in court.

This paper seeks to qualitatively identify the investor control rights typically negotiated by PE funds using a sample of 158 privately held Indian companies which have received investments from non-Indian PE funds in the last five years. This paper will go on to analyse the limitations that Indian corporate and contract law place upon parties' freedom to contract, thus raising the question as to whether the rights negotiated by PE investors are enforceable at all. It is hypothesized that some of these rights may not be enforceable in their customary form.

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1. INTRODUCTION

Private Equity ("PE") funding is a preferred vehicle for corporate growth in India, particularly for privately held, unlisted companies. For 2017-18, PE funds were responsible for approximately USD 24.96 billion in investments in Indian companies.[1] However, due to extant laws and a complex regulatory and compliance environment, PE firms typically do not use the 'leveraged buyout' model typically seen in western countries.[2] Instead, PE firms prefer to take up a minority shareholding position in Indian investee companies.[3] As a result, much like in other jurisdictions, PE investors become co-owners of the company, sharing in risk and returns.[4]

a. Overview of the Indian Private Equity Model

In the Indian context, it is relevant to note the existence of majority shareholders (often referred to as 'promoters' in India), who usually play a ubiquitous role in the management, administration and governance of Indian companies.[5] Majority shareholding is usually passed down from generation to generation, and it is not unusual to see multiple members of the same family occupying leadership positions in family-owned companies even if they lack the desirable qualifications or experience.[6] As a result, minority shareholders, including PE firms, will be concerned with

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[1] Arpan Sheth et al., *Indian Private Equity Report 2018*, BAIN & CO. (Apr. 6, 2018), https://www.bain.com/insights/india-private-equity-report-2018/ [https://perma.cc/S24Q-5E38].

[2] *See* Jeffrey Blomberg, *Private Equity Transactions: Understanding Some Fundamental Principles*, 17 BUS. L. TODAY 51, 51-52 (2008) (explaining the fundamental principles of the private equity transactions).

[3] *See* Afra Afsharipour, *Corporate Governance and the Indian Private Equity Model*, 27 NAT'L L. SCH. INDIA REV. 17, 35 (2015) (discussing how minority investors in Indian firms address corporate governance issues).

[4] *See* DARRYL J COOKE, PRIVATE EQUITY: LAW AND PRACTICE 1 (London, Sweet and Maxwell 2008).

[5] *See generally* Rajesh Chakrabarti et al., *Corporate Governance in India*, 20 J. APPLIED CORP. FIN. 59 (2008) (discussing the history and economic reform of corporate and public sector governance in India).

[6] *See* Arjya B. Majumdar, *India's Journey with Corporate Social Responsibility—What Next?*, 33 J. L. & COM. 165, 182-184 (2015) (exploring the roles of family, culture, and religion in the management of family run firms in India).

the risk of self-opportunism that the Indian model of businesses presents. These include tunneling, pyramidical ownership, cross-holdings, and the use of non-public trusts and private companies to own shares in group companies.[7]

As a result of the Indian PE model, Indian companies receive investment from PE funds in exchange for participation in the investee company's profits through equity, convertible preferred stock, or convertible debt, much like elsewhere in the world.[8] Keeping in mind the concerns related to minority shareholding in India, as part of this investment, the PE fund typically also requires a number of investor control rights negotiated as part of the investment. These rights are either additions to the pre-existing company related statutory rights or enable investors to contract around immaterial or problematic company law provisions.[9] While these rights typically do not interfere with the day-to-day management of the company, they enable investors to offer strategic advice which, in turn, would indirectly preserve (or even enhance) shareholding value,[10] as well as a check and balance against promoter opportunism.

These investor control rights may be broadly divided into two categories, viz. governance and investment protection.[11] Governance refers to mechanisms by which the company is run—including board nomination, quorum rights at board and shareholder meetings and information and affirmative voting rights. Investment protection refers to a wide variety of mechanisms which offer protection against lowered shareholder value for the investor, sometimes at the expense of the company or other shareholders. These may be classified into anti-dilution rights, pre-emptive rights, and preferred payments upon liquidation of the

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7 *See* Umakanth Varottil, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21 NAT. L. SCH. INDIA REV. 1, 16 (2009) (listing these contractual provisions as examples of how controlling family shareholders amplify their power over corporations in countries like India and China).

8 *See* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 914-916 (2002) (comparing the purpose and characteristics of preferred and common stock).

9 *See* JOSEPH A. MCCAHERY & ERIK P.M. VERMEULEN, CORPORATE GOVERNANCE OF NON-LISTED COMPANIES 144 (New York, Oxford University Press 2008) (discussing non-listed companies and their corporate governance framework).

10 *See* Umakanth Varottil, *The Advent of Shareholder Activism in India*, 1 J. GOVERNANCE 582, 610 (2012) (discussing interactive strategies between investors and companies that add value for investor and their limitations).

11 *See* COOKE, *supra* note 4, at 222.

investee company. These rights are encapsulated in an investment agreement or a shareholders' agreement,[12] which records the commercial and behavioural terms of arrangement between the investor, the company[13] and, in the Indian context, the promoters.[14]

Of course, PE funds rely upon a number of other mechanisms to further protect their investment, such as reliance on express representations and warranties, and covenants made by the investee companies and majority shareholders. However, these contractual provisions are not unique to investment or shareholders agreements and, therefore, they will not be part of this paper.

However, the nature of these investor control rights are departures from the default provisions under Indian company law. Further, because these rights are borne out of a contractual arrangement between the investor and the company/promoters, these rights are also subject to Indian contract law. Under the Indian Contract Act of 1872, contracts which are in violation of applicable law are void.[15]

This paper first seeks to empirically identify these special rights typically negotiated by PE investors as part of an investment by way of a private placement of shares in an Indian company. While this has been done for other jurisdictions,[16] this is the first time a comprehensive study of enforceability of shareholders agreement provisions will be conducted with respect to Indian law. Having identified these rights, this paper will go on to perform a doctrinal analysis on the law applicable to these special rights in order to ascertain whether these rights, in the form and manner in which they are expressed, may be enforceable. I hypothesize that there is a significant degree of homogeneity in the kind of rights negotiated by PE investors and that—depending upon the wording of these

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12 *See generally* V. Niranjan & Umakanth Varottil, *The Enforceability of Contractual Restrictions on the Transfer of Shares*, 5 SUP. CT. CASES 1 (2012) (analyzing investor arrangements and their validity and enforceability).

13 *See* COOKE, *supra* note 4, at 189-90; *see also* Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *The Enforceability and Effectiveness of Typical Shareholders Agreement Provisions*, 65 BUS. LAW. 1153 (2010) (explaining, in detail, what shareholders agreement provisions should entail, legal principles, and drafting considerations).

14 *See* Varottil, *supra* note 10, at 612 (noting that most Indian companies have controlling shareholders known as promoters).

15 *See* Indian Contract Act, No. 9 of 1872, INDIA CODE (1872), sec. 23 (outlining lawful and unlawful consideration).

16 *See, e.g.*, Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *supra* note 13, at 1155 (discussing the enforceability of shareholders agreements under New York or Delaware law).

rights in the investment/shareholders agreement—most, but not all, of these rights would be enforceable.

b. Overview of Applicable Indian Company Law

As mentioned above, these special rights negotiated by PE investors are typically crystallized into a shareholders' agreement (sometimes called an investment agreement).[17] These agreements are entered into by the PE investor, the promoter of the company and the company itself. For privately held, unlisted companies, these agreements and their contents are not publicly available—since they primarily deal with the rights and obligations of individual shareholders in a privately held company.

However, under Indian company law, the rights and obligations of shareholders in a company, whether privately or publicly held, are expressed and encapsulated in the Articles of Association or bylaws of the company.[18] These Articles form a part of the constitutional documents of the company and are integral to the company's existence and standing. Based on the Doctrine of Constructive Notice[19]—inherited from the English Common Law system—these Articles are also required to be made publicly available, under sections 7 and 14 of the Indian Companies Act, 2013,[20] along with any subsequent alterations thereof.[21] While the form of the Articles has been prescribed under Tables, F, G, H, I and J in Schedule I of the ICA 2013, companies are enabled to include other matters into the Articles that are necessary for its day to day management.[22] Thus, companies are able to include the special rights of individual shareholders into the Articles.

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17 *Id.*

18 *See* The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 5 (India) (listing what the articles of association of a company should contain).

19 The Doctrine of Constructive Notice expects any person dealing with a company to have knowledge and an understanding of the core constitutional documents of the company—namely the Memorandum and Articles of Association of the company, which are to be made publicly available. *Id.* § 399 (listing the requirements for constructive notice).

20 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India).

21 *See id.* § 14 (explaining the conditions under which articles may be altered to convert a private company into a public company or vice versa).

22 *Id.* § 5(2) (holding that a company may add in articles for matters deemed necessary).

Thus, we note an inherent dichotomy between the public availability of the Articles and the private nature of the shareholders agreement. Both documents deal with the rights and obligations of shareholders and the company. However, through a series of judgments, the Indian judiciary has now established that where there seems to be a conflict between the Articles and a shareholders' agreement, the Articles will prevail.

c. Conflicts between the Shareholders Agreement and the Articles of Association

In *V.B. Rangaraj v. V.B. Gopalkrishnan*,[23] while dealing with a conflict between a shareholders' agreement (SHA) and the Articles of the company, the Indian Supreme Court took the view that the provisions of a SHA imposing restrictions on share transferability even when consistent with the Companies Act, are to be authorized only when they are incorporated in the Articles of the Company. However, in *Vodafone Int'l Holdings v. Union of India*,[24] the apex court seemed to have overturned this view in an *obiter*, holding that an omission of rights available to specific shareholders and mentioned in a SHA but not in the Articles would not, by itself, render the rights unenforceable. The court held that even if such special rights were not mentioned in the Articles, parties aggrieved by a breach of the provisions of the SHA could apply for remedies "under the general law of the land."[25] However, the court also cautioned against rights mentioned in the SHA which run contrary to the Articles. However, this view was not part of the primary discussion of the *Vodafone* judgment therefore, it may be argued that this view may be treated as an obiter, at best. This view was expanded to other conflicts between the Shareholders Agreement and the Articles of Association, beyond rights on share transferability in *IL&FS Trust Co. Ltd. v. Birla Perucchini Ltd.*[26] In the more recent judgment of *World Phone India Pvt. Ltd. & Ors. v. WPI Group Inc.* by the Delhi High Court, the position taken in *Vodafone* was rejected and reliance was placed on *Rangaraj* to hold that "the existence of an affirmative vote cannot be recognized without a corresponding amendment to the

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[23] (1992) 1 SCC 160 (India).

[24] (2012) 6 SCC 613 (India).

[25] *Id.* para. 64.

[26] (2004) 121 Comp Cas 335 (India).

AoA."[27] Since then, the Indian Supreme Court has rejected a special leave petition and did not entertain the matter of *World Phone* further.[28]

Thus, where clauses in shareholders agreements run afoul of company legislation, Indian courts have tended not to favour complete freedom of contract. Even when clauses in shareholders agreements are consistent with established company law, courts have recognized and enforced such clauses only if these have been incorporated in the Articles.[29] This matter was finally put to rest with section 5 of the ICA 2013, which was put into effect in 2014, to the effect that any provisions of the Articles which provide for entrenchment, i.e., where the Articles may be amended by a corporate action more restrictive than a special resolution,[30] ought to be expressly provided for within the Articles themselves.

In other words, where there is a contradiction between the SHA and the Articles of a company, the latter will prevail. As a result, in order to give effect to the rights negotiated by PE investors, the material provisions pertaining to shareholders' rights mentioned in the shareholders agreement are incorporated into the Articles.

Interestingly enough, while most Articles of companies that have a PE investor as a shareholder have been modified to reflect the provisions of the SHA, it is not unusual to note an interpretative clause in the Articles suggesting that the provisions of the SHA would prevail over the Articles. For example, HPL Additives Limited received an investment of USD 10 million from Templeton Strategic Emerging Markets Fund in October 2005.[31] As part of this

[27] (2013) 178 Comp Cas (Del.) 173 (India).

[28] *See* Aditya Swarup, *Conflicts between Shareholders Agreements and Articles of a Company*, INDIACORPLAW (June 6, 2013), https://indiacorplaw.in/2013/06/conflicts-between-shareholders.html [https://perma.cc/Z6LE-5MKU] (discussing how to proceed when there are conflicting provisions in an agreement).

[29] *See* Umakanth Varotill, *Shareholders Agreements: Clauses and Enforceability*, INDIACORPLAW (Dec. 31, 2010), https://indiacorplaw.in/2010/12/shareholders-agreements-clauses-and.html [https://perma.cc/KF8X-KTSN] (outlining Indian court cases that discuss the enforceability of clauses when there are conflicts).

[30] Under § 114 of the The Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India), a special resolution requires three fourths of the shareholders voting in favour of the resolution. An affirmative voting right in favour of a particular shareholder would be an apt example of a more restrictive requirement. *See* The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 114 (India) (explaining the difference between an ordinary and special resolution).

[31] *See Templeton Strategic Invests $10 Million in Indian Specialty Chemicals Company*, domain-b.com (Nov. 21, 2005), https://www.domain-

transaction, the Articles of HPL Additives Limited was amended to reflect the rights available to the investor. The Articles contain the following clause: "In the event of any inconsistency between the clauses hereinafter contained and the Agreement,[32] as defined hereinbelow, the provisions of the Agreement shall prevail."[33]

Given the developments in *Rangaraj*, *IL&FS*, *Vodafone* and more recently, *World Phone*, clauses such as the one mentioned above are clearly no longer enforceable and any rights that Templeton would have negotiated will not be upheld in a court of law. Courts have consistently rejected the notion that shareholders may place reliance upon a SHA for the enforcement of a clause which does not reflect in the Articles and have repeatedly opined that the Articles will always prevail over any agreement entered into by the shareholders.

d. Conflicts between the Articles and Extant Law

However, the Articles are themselves subject to the provisions of prevailing company law. Section 6 of the ICA 2013 provides that—

> Save as otherwise expressly provided in this Act—
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> (a) the provisions of this Act shall have effect notwithstanding anything to the contrary contained in the memorandum or articles of a company, or in any agreement executed by it, or in any resolution passed by the company in general meeting or by its Board of Directors, whether the same be registered, executed or passed, as the case may be, before or after the commencement of this Act; and
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> (b) any provision contained in the memorandum, articles, agreement or resolution shall, to the extent to which it is repugnant to the provisions of this Act, become or be void, as the case may be.

In other words, the provisions of the Companies Act would override the Memorandum or Articles of Association of the

b.com/investments/general/2005/20051121_invests.html [https://perma.cc/8Y9D-G7J6].

[32] Referring to the Shareholders Agreement entered into by HPL Additives Limited, its promoters, and Templeton.

[33] *See* HPL Additives Ltd., *Articles of Association*, art. 1, MINISTRY OF CORP. AFF., GOV'T INDIA, at 5 (June 2, 2018).

company or any other agreement executed, or resolution passed by the company.[34] A similar provision existed in the pre-2013 version of Indian company law[35] and therefore, case law related to the earlier provision would be applicable post-2013 as well.

Through various case law, the judicial trend seems to uphold provisions in the Articles if they are in consonance with the Act. Where the Act is silent, and the Articles provide for a higher standard of governance, courts have also upheld such provisions. For example, in *Kapil N. Mehta, Surat v. Shree Laxmi Motors Ltd.*,[36] the company passed a circular resolution which was allowed by the Articles, but not envisaged under the Companies Act at the time. A claim was raised to render the resolution void as the Companies Act was silent on the matter. The Gujarat High Court dismissed the claim on the grounds (inter alia) that in the absence of a specific law that prohibited circular resolutions, the fact that the Articles enabled the company to pass circular resolutions was not violative of the Companies Act.[37] The Gujarat High Court also placed reliance on *Center v. Rapps*[38] where the King's Bench refused to strike down a by-law merely because it created a new offence applicable only to that company. Instead, the by-law could be held to be repugnant if it makes unlawful that which the general law says is lawful or if it expressly or by necessary implication professes to alter the general law of the land.

However, when the Articles of a company seek or purport to circumvent the law in force, courts have struck such articles down as violative of Section 9, ICA 1956 or Section 6, ICA 2013, as the case may be. For example, when the Articles provided for circulation of a resolution without prior circulation of a draft resolution, in contravention of the ICA 1956, the articles were struck down.[39] In both *O.P Gupta v. Shiv General Finance (P) Ltd.*[40] as well as *Surendra Kumar Dhawan & Ors. v. R. Vir & Ors*,[41] the Articles mandated that

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[34] This has been upheld by a series of judgments before and after 2013 such as ICICI Bank Ltd. v. Sidco Leathers Ltd. & Ors., (2006) 10 SCC 452 (India); Darius Rutton Kavasmaneck v. Gharda Chemicals Ltd., (2015) 14 SCC 277 (India).

[35] *See* The Companies Act, 1956, No. 1, Acts of Parliament, 1956, § 9 (India).

[36] (2001) 103 Comp Cas (Guj.) 498 (1998) (India).

[37] *Id.* paras. 32, 36.

[38] (1902) 1 K.B. 160 at 166.

[39] Mazda Theatres Pvt. Ltd. and Ors. v. New Bank of India, (1975) 1 ILR (Del.) 1 (India).

[40] (1977) 47 Comp Cas (Del.) 279 (India).

[41] MANU/DE/0282/1974 (India).

the internal disputes within the members of the Company shall be mandatorily referred to arbitration. The Courts in each case opined that such an arrangement shall be contrary to the Act which provides for a specific mechanism for the resolution of disputes under Sections 397, 398 and 434 of the ICA 1956. The Madras High Court suggests that it is the duty of the court to read the Articles consistent with extant law. If a harmonious reading is not possible, the Articles will have to yield to the ICA or other laws.[42]

e. Methodology

The Venture Intelligence database records all Venture Capital, PE and M&A deals that involve Indian companies. As of July 2018, approximately 7000 such deals had been recorded for PE alone. Since 7000 deals is too large a sample size for the qualitative study at hand, companies were selected on the following parameters.

1. In the absence of heightened regulatory and compliance thresholds applicable to public listed companies, PE investors tend to negotiate for special rights when investing into privately held companies. Hence, only privately held companies were selected.

2. Due to compliance requirements overseas, a critical assumption was made that foreign PE investors would be more insistent upon meeting corporate secretarial compliance requirements ex-post the investment transaction. As a result, Indian companies which had received funding from foreign PE investors were selected.

3. As this is a study of rights generally negotiated by PE investors as against majority shareholders this study does not concern itself with rights negotiated by multiple PE investors in the same company where differential voting rights and therefore varying levels of control and investment protection rights would be found. Hence, I focused on PE deals that I identified at approximately 263 privately held Indian companies which had received at least USD 5 million as part of a round 1 investment from a foreign PE investor.

Attempts were made to access the Articles of Association[43] of these 263 companies through the website of the Ministry of

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[42] Southern Roadways Ltd. v. Commissioner of Income-Tax, (1981) 130 ITR (Mad.) 545 (1980) (India).

[43] Hereinafter, "Articles."

Corporate Affairs, Government of India. One of the challenges in gathering data in the form of updated Articles was that regularly-updated Articles including special rights would not have been uploaded to the Ministry of Corporate Affairs website. Of course, not all Articles were readily available; many companies remain in default of Sections 7 and 14 of the ICA 2013. As a result, of the 263 companies, the Articles of 158 were accessed and analysed.

f. Initial Analysis

Upon an initial analysis, rights similar to those in private equity transactions in other jurisdictions were found to be present in most, if not all, of these Articles. Most commonly found rights include:

Governance rights

o Board appointment rights by which an investor may appoint one or more directors to the board of the company

o Quorum rights by which a valid, quorate meeting may take place only with the presence of the representatives of the investor

o Veto rights on certain reserved matters, which require the affirmative vote of the investor for a proposed resolution to be passed

o Rights to demand information from the company

Investment Protection

o Pre-emptive rights to participate in future fundraising by the company, with down round price protection

o A 'lock-in' of the shares of the promoter in which the promoter is restricted from transferring its shares while the investor is still a shareholder or for a specified amount of time, along with tag along rights in favour of the investor

o Restrictions on the transfer of shares by the investor in favour of the promoter in the form of a right of first offer (ROFO), right of first refusal (ROFR), and drag-along rights

o Exit rights in the form of an exit by way of an IPO, strategic sale to a third party, or as part of a fresh round of investment, buy-back of shares or a put option in favour of the private equity investor

o A liquidation preference, where the company is required to make a payout equal to the sum of the investment and a pre-determined premium to the investor, in case of a liquidation event, in preference over other stakeholders

This introductory section has set out the basis and background to this paper, focusing on identifying the governance and investment protection issues that PE investors are faced with when taking up a minority position in a promoter-owned, managed and driven company, which is typical of a PE deal in India. We note that in order to mitigate agency costs between the investor (principal) and the promoter (agent), investors negotiate for special rights which are then encapsulated into a shareholders or an investment agreement. We further note that by law, the provisions of the shareholders or investment agreement that impart these rights to the investor must be reflected in the Articles of Association of the company.

The next two sections of this paper will deal with a doctrinal and qualitative analysis of these rights, classified into governance and investment protection rights. Each specific type of right will be taken up and examined against the provisions of the ICA 2013 and applicable case law. It ought to be noted that many provisions of the 2013 Act are reflective or substantially the same as the Indian Companies Act of 1956.[44] Therefore, reliance will be placed on case law prior to 2013 as well. Deviations in the applicable law prior to and after 2013 will be pointed out accordingly. A concluding section will summarize the findings in this paper and will offer suggestions for further research.

2. GOVERNANCE

A PE investor will typically carry out comprehensive legal due diligence prior to engaging in detailed negotiations with the company, its management and promoters in order to discover legal, compliance, and contractual risk.[45] These risks would then be mitigated by a combination of conditions that would be required ex-ante or ex-post the transfer of funds and allotment of securities, or through specific representations, warranties and indemnities[46] in order to provide retrospective comfort to the investor. However, the investor will require prospective assurance after the investment,

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[44] The Companies Act, 1956, No. 1, Acts of Parliament, 1956, § 9 (India).

[45] PRIVATE EQUITY: OPPORTUNITIES AND RISKS 298-99 (H. Kent Baker et al. eds., Oxford University Press 2015)

[46] JEFFREY M. WEINER, *Due Diligence in M&A Transactions: A Conceptual Framework, in* INSIDE THE MINDS: BUSINESS DUE DILIGENCE STRATEGIES 7, 14 (Aspatore Books 2010).

that the funds invested are being used in accordance with the commercial understanding and intent of the parties.[47]

The shareholders agreement will therefore contain a number of negative and positive governance controls over the internal workings of the company which will be crystallized into the shareholders agreement. We will now examine these controls typically found in shareholders agreements, from an enforcement perspective.

a. Appointment of Board Representatives

Barring those matters that, by law, must be deliberated by shareholders (such as alteration of the Articles or of capital) the Board of Directors of a company hold the ultimate authority in terms of day-to-day management of the company, borrowing, lending, investment of the funds of the company, approval of financial statements, declaration of dividend, etc.[48] In order to give effect to the business plan and the manner in which the company is to be governed after an investment transaction, as agreed to between the investor, promoters, and the company, and to ensure that investors have access to company information, investors will typically require that they be able to appoint one or more directors on the board of the company.[49]

For example, in 2015, Rivigo, a company engaged in information technology and enabled services, received funding from two investors, namely, Saif Partners and Spring Canter Investment Limited to the tune of approximately USD 10 million. In doing so, investors picked up approximately 27.42% of the paid-up issued share capital of the company in aggregate.[50] As part of this transaction, each of the investors received the right to nominate one

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47 COOKE, *supra* note 4, at 222.

48 *See* The Companies Act, 2013, No. 18, Acts of Parliament, 2013, § 179(3) (India).

49 *See* Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *supra* note 13, at 1155.

50 Saif and Other Investor Deal with Rivigo, VENTURE INTELLIGENCE DATABASE (April 2015), https://www.ventureintelligence.com/dealsnew/dealdetails.php?value=773222414/0/ (accessible by subscription only). *See also* Anuradha Verma, *Logistics startup Rivigo raises $30M from SAIF Partners, others*, VCCIRCLE (Dec. 17, 2015), https://www.vccircle.com/logistics-startup-rivigo-raises-30m-saif-partners-others [https://perma.cc/RZ8K-XE56].

director to the board of Rivigo, subject to applicable law and provided the investors maintained a minimum shareholding threshold.[51]

In general, the provisions of the ICA require that a director to the Board of a company be appointed only at a general meeting.[52] In the absence of a specific provision requiring a special resolution, it may be surmised that a simple resolution at a shareholders' general meeting may suffice to appoint a regular director. In common law nations, the law has traditionally allowed shareholders to nominate directors.[53] This was the same position in the previous Companies Act of 1956, which also allowed the nomination of a director,[54] and a subsequent appointment at a general meeting.[55] The 2013 statute clarifies this position and adds a special category of a 'nominee' director, provided that the Articles of the company enable the appointment of one.[56] It is interesting to note that while these directors are nominated by individual shareholders or lenders and, for all intents and purposes, serve to represent the interests of the nominating individual or institution, established UK common law suggests that their primary fiduciary duty is to the company itself.[57] This idea of a primary obligation owed to the company exists in Indian law as well.[58]

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51 *See* Rivigo Services Priv. Ltd., *Articles of Association*, art. 18, MINISTRY OF CORP. AFF., GOV'T INDIA, at 15 (Nov. 4, 2016).

52 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 152 (India).

53 *See* Umakanth Varottil, *Nomination of Directors by Shareholders*, INDIACORPLAW (Aug. 28, 2010), https://indiacorplaw.in/2010/08/nomination-of-directors-by-shareholders.html [https://perma.cc/FG4Z-GHKW] (discussing the U.S. SEC's decision to adopt a rule allowing shareholders to nominate directors).

54 The Companies Act, 1956, No. 1, Acts of Parliament, 1956, § 257 (India).

55 *Id.* § 263.

56 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 161(3) (India) ("[S]ubject to the articles of a company, *the Board may appoint any person as a director nominated by any institution in pursuance of* the provisions of any law for the time being in force or of *any agreement* or by the Central Government or the State Government by virtue of its shareholding in a Government company." (emphasis added)).

57 *See* Arjya B. Majumdar, *The Fiduciary Responsibility of Directors to Preserve Intergenerational Equity*, 159 J. BUS. ETHICS 149, 149-151 (2019) (explaining that directors of corporations owe fiduciary duties primarily to the corporation itself, not necessarily individual shareholders). *See also* Peskin v. Anderson [2000] 1 BCLC 372 at 279 (UK).

58 *See* Madhu Kapur v. Rana Kapoor, (2016) 196 Comp Cas (Bom.) 345 (India) (noting that board nominees owe no duty to their nominator or to the controlling shareholders).

A nominee director under the Companies Act may be appointed by the Board as nominated by a financial or other institution or in pursuance of any agreement or by the Government by virtue of its shareholding in a Government company. This provision therefore enables the company to enter into agreements that allow for the nomination and consequent appointment of a director so nominated. However, the question arises as to what happens when an investor requires the appointment of a director and the majority shareholders refuse to do so. Assuming that the person so nominated does not fall afoul of the disqualifying provisions in Section 164 of the Companies Act of 2013, is the Board bound to appoint that particular person? Or is the concept of a nominee director under Indian company law merely suggestive in nature, that since directors must always be appointed by a simple majority vote at a shareholders meeting, that the composition of the Board must ultimately be determined by the majority shareholder?

In a case before the Company Law Board, it was held that if the articles provide that share qualification is not applicable in the case of persons nominated by certain shareholders as directors on the board, the same is not contrary to Section 273 of the ICA 1956 and, therefore, the application of Section 9 of the ICA 1956 does not arise. [59] This question was also indirectly referred to in *K. Radhakrishnan v. Thirumani Asphalts & Felts (P.) Ltd. & Ors*[60] where the articles provided for a particular individual to be appointed as a lifetime director. The Madras High Court upheld the same. However, where the appointment of a director was made as per the provisions of a will of a director who had passed away, the Bombay High Court held that this amounted to an assignment of the post, which was violative of the ICA 1956 and the will and articles were struck down to that extent.[61]

In *Kashinath Tapuriah v. Incab Industries Ltd.*,[62] the Articles authorized certain individuals to appoint and remove the chairman of the company. Accordingly, the chairman had been appointed. Subsequently however, in the absence of the regular chairman of the Company, the existing chairman was removed via a resolution passed by the Board pursuant to an article authorizing the board to

[59] Mrs. Aruna Suresh Mehra v. Jifcon Tools Pvt. Ltd. & Ors., (1998) 94 Comp Cas 329 (India).

[60] MANU/TN/0391/1999 (India).

[61] Oriental Metal Pressing Works (P) Ltd. v. Bhaskar Kashinath Thakoor, (1960) 30 Comp Cas (Bom.) 682 (India).

[62] (1998) 93 Comp Cas (Cal.) 725 (India).

appoint a chairman only for a particular meeting. This was contrary to the Articles. However, the Supreme Court held that in the absence of the individuals who held the right to appoint the forthcoming chairman to enforce their rights, the board was authorised to remove the chairman so appointed by such individuals and refused to interfere with the internal management of the Company.[63]

This question was raised more recently before the Bombay High Court in *Madhu Ashok Kapur v. Rana Kapoor*[64] where the court was of the opinion that a provision in the Articles that allowed for a particular shareholder to nominate a director cannot be merely suggestive. Any shareholder would be able to suggest directorial nominations at a shareholders meeting, even without an enabling provision in the Articles. The fact that the Articles of the company specifically allowed a particular shareholder to nominate a director meant that the majority shareholder, along with the Board, would be required to appoint a director so nominated. The court also pointed out that a nominee director is appointed by the Board and not by the majority shareholder[65] and that the Board must act in accordance with the provisions of the Articles.[66]

With the reluctance of the Supreme Court to interfere in the internal matters of *Kashinath* and confirmation by the Bombay High Court in *Madhu Kapur*, we may safely argue that the right to nominate specific individuals to the Board of a company by agreement—in this case, the shareholders agreement—is perfectly enforceable and legitimate, provided that the same right is reflected in the Articles and that it does not violate the provisions of the ICA 2013.

In terms of drafting considerations, the shareholders agreement, and therefore, the Articles, must unequivocally suggest that the investor shall have the right to nominate and maintain one or more directors as may be negotiated. In order to further protect the investor, the clause ought to place obligations upon the promoters to vote in accordance with the nomination of the investor and upon the Board to effect the appointment of the nominee director. Lastly,

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63 *Id.* paras. 118-19.

64 (2016) 196 Comp Cas (Bom.) 345 (India).

65 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 §161(3) (India).

66 *Id.* §179(1) (stating that "the Board shall be subject to the provisions contained in that behalf in this Act, or in the memorandum or articles").

in the event of a vacancy of the nominee seat, the investor alone ought to have the right to appoint a replacement.

b. Quorum Rights at Board and Shareholder Meetings

To conduct a valid meeting in a Company, a minimum number of persons must be present in the meeting—whether at the Board or the shareholder level—for the transaction of business, called a quorum. While various provisions exist to require a minimum number of persons, there is no express provision under the ICA 2013, which deals with any special quorum rights and generally with any special rights granted to a specific shareholder or board member. At the same time, the law does not expressly provide for a restriction on any such special quorum rights being provided to a shareholder or board member.

A PE investor will typically require that a shareholders meeting and, less typically, a board meeting not be quorate without the presence of the representative or the board nominee of the PE investor.[67] This is likely to be a contentious issue since promoters may not want to offer opportunities for the business and management of the company to be frustrated by the non-attendance of the investor nominee. However, measures may be taken to ensure that quorum rights do not result in a deadlock of management.

For example, in June 2018, a group of PE firms including SeaLink Capital Partners, JS Capital, and Quantum Funds invested USD 29.5 million for a 56.34% stake in Surya Children's Medicare Private Limited, a company engaged in the ownership and management of a number of women and child-care specific hospitals throughout India.[68] As part of this transaction, the investors and promoters agreed that for a quorate board meeting to take place, at least one nominee each from investors and promoters be present at all times

[67] GEOFF YATES & MIKE HINCHLIFFE, A PRACTICAL GUIDE TO PRIVATE EQUITY TRANSACTIONS 162-163 (Cambridge, Cambridge Univ. Press, 2010) (discussing director appointments and quorum requirements for general and board meetings).

[68] Sealink deal with Surya Children's Medicare Priv. Ltd., VENTURE INTELLIGENCE DATABASE (June 2018), https://www.ventureintelligence.com/dealsnew/dealdetails.php?value=348678079/0/Surya (accessible by subscription only). *See also* Joseph Rai, *Sealink Buys Out OrbiMed From Surya Children's Medicare, injects fresh funds*, VCC NEWSCORP (June 15, 2018), https://www.vccircle.com/sealink-buys-out-orbimed-from-surya-childrens-medicare-injects-fresh-funds/ [https://perma.cc/VYW8-ECXX].

throughout the board meeting.[69] In order to avoid a frustration of management due to the non-attendance of either representative, any meeting for which valid quorum is not met within thirty minutes of the scheduled time, will be automatically adjourned to the same venue, time and day of the next week. If quorum is not met at the adjourned meeting either, the meeting shall get adjourned a second time to the same venue, time, and day of the following week. However, adjournments ought to not continue *ad infintum*. If quorum is not met at the second adjourned meeting due to the specific absence of the investor-nominated director, the meeting will take place regardless, as if the investor nominee were present.[70] However, irrespective of the number of meetings adjourned, these Articles also provide that in the absence of the investor nominee, the Board cannot transact on matters that require the affirmative consent of the investor,[71] unless such prior written consent has been obtained.[72]

In terms of the ICA 2013, a "quorum" for a valid board meeting consists of "one-third of a company's total strength or two directors, whichever is higher."[73] The ICA does not provide for special quorum rights to specific shareholders, although there is no express restriction on incorporation of such rights. While Indian courts have acknowledged the presence of quorum rights negotiated by private equity investors,[74] the enforceability or validity of having a quorum requirement higher than what is provided for has been dealt with on a few instances. In *Amrit Kaur Puri v. Kapurthala Flour, Oil and General Mills Co. P. Ltd*,[75] the Punjab and Haryana High Court took the view that a quorum for meetings provided for in the Articles may be higher than that provided for in the ICA 1956. Similarly, in *Uma Shankar Gupta v. Vishal Promoters Pvt. Ltd.*,[76] the Calcutta bench of the National Company Law Tribunal had the occasion to consider

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69 Surya Children's Medicare Priv. Ltd., *Articles of Association*, art. 3.13, MINISTRY OF CORP. AFF., GOV'T INDIA, at 5 (June 2, 2018).

70 *Id.* art. 3.14.

71 *See infra* Section 2(c).

72 *Id.* art. 3.15.

73 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 174 (India).

74 *See, e.g.*, Vodafone Int'l Holdings v. Union of India, (2012) 6 SCC 613 (analyzing the enforceability of a shareholders agreement which mandated that a meeting of the board of directors only constituted a quorum if a nominee of Vodaphone was present).

75 (1984) 56 Comp Cas (P&H) 194 (India).

76 (2017) 203 Comp Cas (Cal.) 520 (India).

whether the Articles of a company may prescribe a higher number of directors to be present for a valid, quorate meeting. The NCLT opined in the affirmative, stating that the higher number prescribed in the Articles would not be ultra-vires to the Indian company law.[77]

This seems to resonate well with the overall view that if the Articles of a company provide for a higher standard than what is required in the ICA 2013, then such clauses would be perfectly enforceable.

A specific clause granting quorum rights ought to include language that no valid meeting may take place without the presence of the investor representative or nominee. Further, in the event that the meeting is required to be adjourned for want of quorum, the clause should specifically state the mechanism of holding the adjourned meeting and a requirement of fresh notice, if any. Parties ought to establish the number of times a meeting may be adjourned for want of quorum before it may be finally held in the absence of the investor representative. Of course, in the interests of the investor, the quorum rights clause must mention that at no stage may a matter requiring an affirmative vote of the investor be passed unless in the presence of the investor representative or with the written consent of the investor.

In terms of shareholder meetings, the statutory requirement of a quorum in a public company is five, fifteen, or thirty members, depending upon the total number of members and two members in the case of a private company. However, Indian company law makes a specific allowance for the Articles to require a higher number of members to be present in order for a meeting to be quorate. Having said that, the Companies Act is silent as to whether a company may be bound to conduct a shareholders meeting only with the presence of a particular shareholder.

c. Reserved Matters/Veto Rights

Ordinarily, most issues that are part of the day to day management of the company are dealt with by the Board.[78] Other matters, such as the appointment of the Board itself, are subject to shareholder approval, which is obtained at a meeting of shareholders through simple majority—commonly referred to as an

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[77] *Id.* para. 26.

[78] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 179 (India).

ordinary resolution.[79] However, there are matters which are of some significance to the foundation of the company and may have far reaching consequences which are subject to a special resolution, requiring a three-fourths majority vote in favour of the resolution. This is a remnant from English partnership law, which required unanimous consent of all partners in a firm to carry out certain actions.[80] However, there are certain matters that are considered to be more important than those requiring a special resolution and require the affirmative vote of a particular investor or set of shareholders.

Reserved or veto or affirmative vote matters or consent rights are issues that are of particular importance to the investor.[81] These are contractually-agreed matters provided in a joint venture agreement or a shareholders agreement that need consent of all or specific partners before being approved and implemented.[82] This issue assumes even more importance from the contractual perspective. What then stops a majority promoter from unilaterally altering the terms attached to the investor shares? As a result, rights available to certain shareholders as mentioned in the Articles may be protected from amendment by requiring that any amendment of the Articles requires the affirmative consent of the investor.

For example, in July 2006, Lemon Tree Hotels received an investment of USD 72.17 million from Warburg Pincus, who picked up a 24% stake in the company.[83] As part of this investment, the fund required that the following Affirmative Voting Rights be granted to each of the main shareholders of the company:

> *Subject only to any additional requirements imposed by the Act and Article 64.2 below, and notwithstanding anything to the contrary in these Articles, neither the Company nor Winsome nor any Shareholder, Director, officer, committee, committee member,*

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[79] *Id.* § 114.

[80] Partnership Act 1890, 53 & 54 Vict. c. 39, § 19 (Eng.).

[81] Cyril S. Shroff & Vandana Sekhri, *Indian Update—Companies Act, 2013—Impacting M&A Deals*, XMBA FORUM (Sept. 4, 2013), http://xbma.org/forum/indian-update-companies-act-2013-impacting-ma-deals/ [https://perma.cc/65MW-X7TP].

[82] Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *supra* note 13, at 1170.

[83] Swaraj Singh Dhanjal & Sneh Susmit, *Warburg Pincus set to exit Lemon Tree Hotels*, LIVEMINT (Mar. 20, 2018), https://www.livemint.com/Companies/oAjkmYinmO5aFd7N0FjuRL/Warburg-Pincus-set-to-exit-Lemon-Tree-Hotels.html [https://perma.cc/VJ4Y-HNE3].

employee, agent or any of their respective delegates shall, without the affirmative written consent or approval of at least one (1) nominee Director of each of the Principal Shareholders take any decisions or actions in relation to any of the matters set forth below (the Affirmative Vote Items), whether in any Board Meeting, General Meeting, through any resolutions by circulation or otherwise, with respect to the Company, Winsome or any Subsidiaries:

(a) Any material change in the nature and scope of the business.

(b) For each of the Financial Years ending on March 31, 2007, March 31, 2008 and March 31, 2009, any cumulative capital expenditure in each such Financial Year in excess of the higher of (i) Rs. 500,000,000 (Rupees Five Hundred Million) and (ii) an amount equal to three times the aggregate EBIDTA of the Company and Winsome, including the pro-rated share of the EBIDTA in their Subsidiaries based on their respective shareholdings in such Subsidiaries in the immediately preceding Financial Year (based on the most recent Financial Statements of the Company, Winsome and their respective Subsidiaries) in a single or a series of transactions. For each of the Financial Years after March 31, 2009, any cumulative capital expenditure in such Financial Year in excess of an amount equal to two times the aggregate EBIDTA of the Company, Winsome including the pro-rated share of the EBIDTA in their Subsidiaries based on their respective shareholdings in such Subsidiaries in the immediately preceding Financial Year (based on Financial Statements of the Company Winsome and their respective Subsidiaries for such Financial Year) in a single or a series of transactions. Disposal of assets which results in a capital receipt in excess of Rs. 100,000,000 (Rupees One Hundred Million only) in a single or a series of transactions in any Financial Year.

Till such time as the transactions contemplated under Clause 5 of the Shareholders Agreement are completed in accordance with the terms thereof:

(i) any disposal of assets or investments in Winsome;

(ii) any revaluation of assets of Winsome; and/or

(iii) undertaking any new projects or commitments in Winsome.

(c) Other than as specially required to give effect to the transactions contemplated by the Transaction Documents, any increase, decrease, or other alteration or modification in the authorized or issued, subscribed or paid up Equity Share Capital, or re-organization of the share capital, including new issue of Equity Securities or other securities or any preferential issue of shares (voting or non- voting) or redemption, delisting, buy-back of any shares, issuance of warrants or securities, or grant of any options over its shares, determining the timing, pricing, place, stock exchange in relation to any initial public offering, entering into any shareholder, joint venture or similar agreement or voting or other arrangement with a third party, which provides rights to a third party relating to governance of the Company, Winsome, and/or any of the Subsidiaries, including veto rights, and representation on the Board.

(d) Any amendments or modifications to the Charter Documents;

(e) Related party transactions with any of the Principal Shareholders and/or their Affiliates, other than the Management Resolution and arrangements with Current Investor 2 and/or their Affiliates for procurement of food and beverages for the hotels operated by the Company, Winsome and/or the Subsidiaries, provided that each of the aforesaid are carried out on an arms length basis and in compliance with the provisions of the Act.

(f) The creation of any Debt beyond an overall Debt: equity ratio of 1.50: 1.00 on a consolidated basis.

(g) Appointment or re-appointment of any Person other than Ernst & Young, KPMG, or, PricewaterhouseCoopers as statutory auditors.

(h) Acquisition of shares or assets of other businesses, creation of subsidiaries joint ventures / partnership, mergers, de-mergers, consolidations, winding up and/or liquidation of the Company, Winsome or any Subsidiaries, any event that reduces the ownership of the Company or Winsome in any of their Subsidiaries, inviting any other entity or Person to participate or share in any ownership interest or revenue of any projects or any change in the existing ownership interest or revenue of any projects of the Company, Winsome or the Subsidiaries including but not limited to the projects.

(i) Issuance of any shares, options or securities pursuant to the ESOP beyond 7.5% of the Equity Share Capital or any changes to the terms and conditions of the ESOP or any proposal for replacement of the ESOP with a new plan or scheme.

(j) Other than in relation to Tangerine, in which case the amount of the obligations shall not exceed Rs. 1,000,000 (Rupees One Million only) in aggregate in a Financial Year, (i) providing any security for and on behalf of any Person (other than the Company, Winsome or the Subsidiaries); or (ii) creating any Encumbrance over the assets of the Company, Winsome or any of the Subsidiaries on behalf of any Person (other than the Company, Winsome or the Subsidiaries); or (iii) providing any loan to any Person (other than the Company, Winsome or the Subsidiaries); or (iv) guaranteeing the Debts of any Person (other than the Company, Winsome or the Subsidiaries). Provided that nothing contained herein shall be construed as permitting the creation of any Debt beyond an overall Debt: equity ratio set out in (f) above.

(k) Any delegation of any of the above.

(l) Any commitment, arrangement, or agreement, verbal or written to do any of the foregoing.[84]

It will be noted that most of the critical operations of the company, such as material changes in the business of the company, fresh issue of capital, limitations on capital expenditure and debt, appointment of auditors, amendments to the Memorandum and Articles of Association of the company, etc., all require an affirmative vote. In this case, from not just a single shareholder, but multiple.

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[84] Krizm Hotels Priv. Ltd., *Articles of Association*, art. 64.1, MINISTRY OF CORP. AFF., GOV'T INDIA, at 26.

Opinions are divided as to the enforceability of affirmative voting rights.[85] The ICA 2013 allows for entrenchment provisions in the articles. That is to say, specified provisions of the articles may be altered only if conditions or procedures that are more restrictive than those applicable in the case of a special resolution are met or complied with.[86] Thus, a clause requiring an affirmative vote of a particular shareholder for any amendment in the Articles will be enforceable. This has significant ramifications in terms of enforceability of shareholder rights.

Ordinarily, any amendment in the Articles requires a special resolution.[87] Therefore, any proposed changes in the rights and obligations of the parties may be blocked by a shareholder holding at least 25%. However, it is not unusual to see PE investors taking up a stake of less than 25%. Out of the 158 transactions surveyed as part of this paper, 101 involved investors taking up 25% or less stake in their investee companies. In such transactions, even if the special rights accorded to the investor have been inserted into the Articles, in the absence of entrenchment provisions in the form of affirmative voting rights or veto rights or reserved matters, there is nothing to stop a promoter holding in excess of 75% from altering these rights at will. As a result, as long as there are entrenchment provisions in the Articles, the rights negotiated by the investor and inserted in the Articles will be safe from unilateral amendment by a promoter holding a super-majority. It is a different matter, however, whether those rights are enforceable.

For example, in *Feroz Bhasania v. United Breweries*,[88] the Calcutta High Court was seized of a matter involving the change of name of a company, which was barred by an agreement between shareholders. It was of the opinion that a company may change its name by a special resolution and that this right cannot be restricted by agreement.[89] As a result, the agreement between shareholders

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[85] *See* Padmanabhan Iyer, *Veto Rights Relating To Quorum And Voting On Resolutions—Whether Enforceable Under The Indian Companies Act, 1956?*, MONDAQ (Jul. 25, 2003), http://www.mondaq.com/india/x/22063/Corporate+Commercial+Law/Veto+Rights+Relating+To+Quorum+And+Voting+On+Resolutions+Whether+Enforceable+Under+The+Indian+Companies+Act+1956 [https://perma.cc/2NLT-M6QM].

[86] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 5(3) (India).

[87] *Id.* § 5.

[88] (1971) ILR 1 (Cal.) 367 (India).

[89] *Id.* para. 10.

was held to be void.[90] In the case of *In Re: Jindal Vijayanagar Steel*,[91] the Articles provided for a change in the registered address of the company on terms more onerous than a special resolution.[92] The CLB held that this was violative of the ICA 1956.[93] However, both changes to the name of the company as well as the registered address require amendments to the Articles of the Company, which, in a post 2013 regulatory environ, is now protected under Section 5(3) of the ICA 2013.

This protection to minority shareholders holding affirmative voting rights is further bolstered when powers of the Board are made subject to the Articles.[94] For example, the Board is empowered to carry out acquisition of shares or assets or properties under the ICA 2013.[95] However, this is subject to an affirmative vote in the case of Lemon Tree Hotels and Warburg as mentioned above. As long as these reserved matters are provided for in the Articles, the powers of the Board will continue to be restricted, and these restrictions will be enforceable as against the Board.

However, the appointment of auditors cannot be carried out by the Board and requires a simple resolution at a general meeting.[96] This right of the shareholders has not been made subject to the Articles in the ICA 2013. The reserved matters clause of Lemon Tree suggests that the company may appoint one of three Big Four audit firms as its auditors. While this may seem like a higher standard to be met by the company, it is difficult to ascertain whether a cause of action against the appointment of an auditor other than the ones mentioned in the Articles of Lemon Tree would be maintainable.

Thus, a provision that requires the affirmative consent of a particular shareholder for the amendment of articles, or any matter typically carried out by the Board, will be upheld. However, the same cannot be said about reserved matters outside of these two categories.

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90 *Id.* para 11.

91 (2006) 129 Comp Cas 952 (India).

92 As required under The Companies Act, 1956, No. 1, Acts of Parliament, 1956, § 17 (India).

93 In Re: Jindal Vijayanagar Steel (2006) 129 Comp Cas 952, paras. 7-8 (India).

94 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 proviso to § 179(1) (India).

95 *Id* § 179(3)(k).

96 *Id.* § 139.

d. Information Rights

Investors will often negotiate for rights to receive or examine certain financial data or other types of information in the company independent of information rights received as a member of the Board.[97] For example, when Norwest Venture Partners FVCI-Mauritius invested approximately USD 10 million for a 25% stake in Migliore Webcommunity Private Limited in November 2006,[98] one of the terms negotiated a detailed set of information rights as follows:

> 1. Information rights given to the Investor (Norwest), unless the information has already been provided to the Board of the company:
>
> a. Audited annual financial statements within 90 (ninety) days after the end of each fiscal year.
>
> b. Un-audited monthly financial statements within 30 (thirty) days of the end of each month.
>
> c. An annual budget within 45 (forty-five) days of the end of each fiscal year for the following fiscal year.
>
> d. Annual business plan (including quarterly budget containing an income statement, a statement of cash flow, a balance sheet and detailed break-down of working capital) and headcount, no later than 15 (fifteen) days of the end of each fiscal year for the following fiscal year.
>
> e. Brief quarterly reports including a narrative describing the Company's progress during the prior quarter within 45 (forty-five) days of the end of the relevant quarter.
>
> f. Any material information including resignation of any member of the Key Employees including persons above the designation of general manager, or Directors, within a maximum period of 7 (seven) days.

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[97] Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *supra* note 13, at 1171.

[98] S. Bridget Leena, *Sulekha.com raises Rs175 Cr from GIC and Norwest Venture Partners*, LIVEMINT (Apr. 21, 2015), https://www.livemint.com/Companies/zSLtCv6K9FrVpmPDsv7Z4O/Sulekhacom-raises-Rs175-cr-from-GIC-and-Norwest-Venture-Par.html [https://perma.cc/SK7G-D3MX].

> 2. Information rights given to the Board: The Company shall provide a quarterly reporting package to the Board of Directors, which shall include all the necessary information required by any Director and will include monthly management accounts and updated cash flow forecasts. The Company shall deliver to the Investor the Company's annual budget, as well as audited annual and un-audited monthly and quarterly financial statements. Furthermore, as soon as reasonably possible, the Company shall furnish a report to the Investor comparing each annual budget to such financial statements.[99]

In addition, Norwest was also entitled to reasonable inspection and visitation rights. These information rights are typical of private equity transactions across the world.

Under the provisions of the Companies Act 2013, shareholders have statutory rights to inspect the minute books of general meetings,[100] the Register of directors, key managerial personnel and their shareholdings,[101] and any document, record, register, minute, etc., which are required to be kept by a company.[102] These documents may be maintained and inspection shall be allowed for in electronic form as well.[103] A Kolkata Bench of the National Company Law Tribunal upheld these inspection and information rights for shareholders of private companies.[104] In addition, shareholders must receive a copy of the audited financial statement along with the auditors' report at least 21 days prior to the annual general meeting.[105]

Therefore, it seems to be fairly well-established that shareholders are entitled to certain information rights, which may be categorized into two classes. The first is information rights arising out of an application or initiation by the shareholder, i.e., the right to inspect statutorily required registers, minutes, and other documents as is highlighted in the provisions of the Companies Act

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99 Migliore Webcommunity Priv. Ltd., *Articles of Association*, art. 65, MINISTRY OF CORP. AFF., GOV'T INDIA, at 30-31.

100 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 119 (India).

101 *Id.* § 171.

102 *Id.* § 120.

103 *Id.*

104 *See* M/s. Gopalpur Ports Ltd. v. M/s. Sara Int'l Private Ltd., (2015) SCC OnLine CLB 293, Kolkata Bench (India).

105 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 136 (India).

mentioned above. The second category of information rights seems to require a corporate action of proactively providing such information to the shareholder, as seen in Section 136 of the Companies Act. It is interesting to note that the information rights stipulated in the Articles of Migliore, as with many other investee companies, require higher standards and frequency of information to be sent by the Company to the investors. The question arises as to whether the investor would have any recourse under the Companies Act, 2013, in the event of a breach of these standards.

We have seen in other cases that courts will generally uphold a set of standards provided for in the Articles that are more stringent than what is required under basic company law.[106] As a result, clauses in the Articles that require the company to provide more information than what is necessary under the ICA 2013 would not be in violation of Section 6 of the ICA 2013.

3. INVESTMENT PROTECTION

As noted above, certain clauses in the Shareholders Agreement, and therefore in the Articles, offer investors a rudimentary oversight and control over the investee company. These ensure that the funds made available by the investment are being expended in accordance with the business plan of the company or on mutually agreed commercial terms. However, the eventual goal of the investor is to exit the company by way of a sale of its shares to a third-party buyer who will replace the investor, or ideally, by way of an initial public offering. In the interim, parties must ensure that the value of the investor's shareholding does not diminish. Further, there must be appropriate protections for promoters when investors exit the company by way of sale. These are clauses which protect the investor's share value which we will now proceed to examine.

a. Participation in Future Fundraising by the Company

Future rounds of investment which involve fresh issues of equity will inevitably dilute the existing shareholding of the investor. Dilution is the reduction of a shareholder's ownership

[106] Kapil N. Mehta, Surat v. Shree Laxmi Motors Ltd., (2001) 103 Comp Cas (Guj.) 498 (India).

percentage in a company due to an increase in the paid up share capital.[107] Provisions that protect the investor against (i) dilution of capital and (ii) dilution of capital at a lower share price are fundamental to the investor's shareholding position.[108] As a result, most investors will require that any fresh rounds of investment be subject to the affirmative consent of the investor. In many cases, the investor will also require that the new shares be offered to itself first, before the shares are offered to third parties.

For example, in a subscription of compulsorily convertible debentures of Bhoruka Power Corporation Limited by Darby Asia Mezzanine Fund II LLP, the investor required that any further issue of capital be first offered to the promoters and other shareholders of the company and that the Investor would have the right to subscribe to shares on terms as beneficial as those being offered to a third party.[109] The Articles further provided for an affirmative voting right in favour of the Investor as to further issue of shares.[110] These clauses ensure that if there is a fresh round of equity funding, it must be done with the affirmative consent of the investor and the first offer must be made to the investor itself. However, the question arises as to whether such clauses are enforceable.

The ICA 2013 requires a special resolution to be passed by the shareholders at a general meeting[111] in order to make a further issue of shares. This provision effectively builds in a statutory anti-dilution clause. Therefore, a company cannot issue further capital without the affirmative consent of an investor holding shares in excess of 25% of the paid-up share capital. However, investors with a shareholding of less than 25% may yet seek an affirmative voting right as noted in Bhoruka above. In a matter before the Karnataka High Court, the Articles provided for a higher standard to be maintained or an additional step to be taken, prior to the authorization of a fresh issue of shares. The Karnataka High Court

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[107] Casey W. Riggs, *Venture Capital Term Sheet Negotiation – Part 7: Anti-dilution Provisions*, STRICTLY BUS. (Mar. 8, 2014), https://www.strictlybusinesslawblog.com/2014/03/08/venture-capital-term-sheet-negotiation-part-7-anti-dilution-provisions/[https://perma.cc/J6QS-DGAK].

[108] COOKE, *supra* note 4.

[109] Bhoruka Power Corp. Ltd., *Articles of Association*, art. 6, MINISTRY OF CORP. AFF., GOV'T INDIA, at 7-8.

[110] *Id.* art. 16, at 13.

[111] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 §62(1) (India).

was of the view that this higher standard would not be violative of the ICA 1956.[112]

However, many investors will also include provisions of 'anti-dilution' which apply to occasions when shares are being issued at a value lower than that of the existing investor.[113] Since this erodes the shareholding value, the existing investor may seek compensation for such loss. There are primarily two methods by which such compensation is calculated and paid. The first is the full ratchet method where the share price of the existing shareholders is revised to reflect the price of the new issue and additional shares are issued to the existing investor at no cost to the investor. This is generally seen to be onerous and burdensome on the promoters and the company.[114]

The other method, which is generally more accepted, is the weighted method. This method takes into account the pre-issue paid-up share capital as well as the number of shares to be issued. For example, when Phasorz Technologies Private Limited received an investment from a number of investors including Bessemer,[115] the investors required that for any subsequent issues of equity at a price lower than what was offered to them (commonly referred to as a 'down round'), Phasorz must use a broad based weighted average to recalculate the share price for Bessemer and other shareholders.[116] This adjustment in the share price takes into account (i) the prevailing price of the shares; (ii) the aggregate number of all the equity shares outstanding immediately prior to the dilutive issuance reckoned on a fully diluted basis; (iii) the per share consideration received by the Company from new investor; and (iv) number of

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112 *See* I.T. Cube India (P.) Ltd. v. I.T. Cube Inc., MANU/KA/8271/2006 (India) (holding that the Articles provided that the Directors had full control over who shares could be allotted to and under what terms, subject to the sanction of the company in general meeting).

113 Paul Albert & Ashwin Bhat, *Anti-Dilution Protection in Shareholders Agreement-Implementation Under Indian Laws*, MONDAQ (Nov. 1, 2018), http://www.mondaq.com/india/x/750920/Shareholders/AntiDilution+Protection+In+Shareholders+Agreement+Implementation+Under+Indian+Laws [https://perma.cc/PD8J-7C9A].

114 Riggs, *supra* note 107.

115 Yuvraj Malik, *DocsApp Raises $7.2 Million from Bessemer Venture Partners, others*, LIVEMINT (Dec. 12, 2017), https://www.livemint.com/Companies/KMTcsku6LRIiqOe27LcljK/DocsApp-raises-72-million-from-Bessemer-Venture-Partners.html [https://perma.cc/39VU-S7X5].

116 Phasorz Technologies Priv. Ltd., *Articles of Association*, Sched. 4, MINISTRY OF CORP. AFF., GOV'T INDIA, at 69.

shares actually issued in the dilutive issuance (on a fully diluted basis).

The ICA 2013 allows for a further issue of shares to the existing shareholders of the company, either as a rights issue[117] or as a bonus issue.[118] The provisions applicable leave it open-ended as to the pricing of the rights issue and therefore, a private company would be able to issue shares to its existing shareholders at a price it deems fit. However, a bonus issue requires an enabling provision in the Articles of the company and may be made by converting the company's free reserves, securities premium account, or its capital redemption reserve account into paid up capital. Thus, provisions relating to anti-dilution would be enforceable under the ICA 2013.

b. Restrictions on Transfer of Shares

Share transferability is restricted under Indian law for private companies.[119] This is done for a variety of reasons. Indian companies tend to be closely held, even more so when private and unlisted and there remains a strong disincentive for promoters against allowing 'outsiders' to gain access to their company shareholding which would include access to the company's confidential information. As a result, parties would like to "know who they are investing with."[120]

On the other hand, because Indian companies are driven strongly by an individual promoter, their immediate family or a close-knit network of associates,[121] any transfers of shares by these promoters would signal a lack of confidence in their own company. PE funds would understandably, be wary of any share transfers by promoters. As a result, promoters are almost always restricted from transferring their shares without the affirmative consent of the investors. This feature, commonly referred to as a 'lock-in' also finds its way into public issues of shares where promoters are required to hold at least twenty percent of the post issue paid up capital of the

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117 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 62(1)(a) (India).

118 *Id.* § 63.

119 *Id.* § 2(68) (explaining that the nature of a private company requires that it restrict the right of shareholders to transfer shares).

120 Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *supra* note 13, at 1172.

121 Varottil, *supra* note 7.

company.[122] Promoters are restricted from transferring this minimum of twenty percent for a period of three years and are restricted from transferring any shares in excess of twenty percent for a period of one year.[123]

At the same time, promoters would also require some form of stability as to the presence of the investor. If an investor is allowed to transfer shares at will, the promoter may require some restrictions as to a minimum moratorium on the transfer of shares and post that moratorium, some control over who the investor shares may be sold to.

For example, when IHHR Hospitality Private Limited accepted a USD 55 million investment from Morgan Stanley in March 2007,[124] the investor and promoter agreed to a common lock-in period of three years from the date of investment.[125] This meant that no shareholder could transfer their shares without the express prior written consent of the other shareholders. Upon the expiry of this three year time period, the investor would be entitled to transfer their shares, subject to a right of first refusal[126] in favour of the promoter.

The question of whether shareholders may bind each other in an agreement restricting the transfer of their shares has been debated for a while.[127] Through a series of cases,[128] it was held that no restrictions on share transfers could be enforced unless specifically incorporated into the Articles.

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[122] Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, § 14, Gazette of India, pt. III sec. 4 (Sept. 11, 2018) [hereinafter ICDR 2018].

[123] *Id*. § 16.

[124] Sudipto Dey, *Morgan Stanley to Take 20% In IHHR*, ECON. TIMES (Apr. 6, 2007), https://economictimes.indiatimes.com/industry/services/hotels-/-restaurants/morgan-stanley-to-take-20-in-ihhr/articleshow/1862813.cms?from=mdr [https://perma.cc/4VXZ-TVVR].

[125] IHHR Hospitality Priv. Ltd., *Articles of Association*, art. 17, MINISTRY OF CORP. AFF., GOV'T INDIA, at 7.

[126] *See infra* Section 3(c).

[127] Niranjan & Varotill, *supra* note 12.

[128] *See, e.g.*, VB Rangaraj v. VB Gopalakrishnan, (1992) 1 SCC 160 (India); Messer Holdings Ltd. v. Shyam Madanmohan Ruia & Others, (2010) 159 Comp Cas (Bom.) 29 (India); Vodafone Int'l Holdings v. Union of India, (2012) 341 ITR 1, at 63 (India).

While Indian law requires restrictions on the transferability of shares in private companies,[129] the transferability of shares cannot be restricted in public companies.[130] Further, under the proviso to Section 58(2) of the ICA 2013, parties may enter into contracts or arrangements in respect to transfer of securities and these will be enforceable as a "contract."[131] However, this approach under the ICA 2013 has received criticism on the grounds that it does not clearly set out the conventional wisdom that shares of a private company are, by virtue of Section 2(68) of the ICA 2013, subject to greater restrictions on transferability than in the case of a public company.[132] The extant case law, and therefore the position in law, seems to focus on the board's ability to reject a transfer of shares in pursuance of adhering to the Articles.[133]

As of now, the ruling in *Messer Holdings,* when read with the provisions of Section 58 of the ICA 2013 seems to suggest that shareholders, whether of a private or a public company, may choose to restrict the transferability of their shares.[134] In the case of private companies, the restriction must be set out in the Articles. Under Section 58(1) of the ICA 2013, the board must necessarily reject those transfers that are not in consonance with the Articles.[135]

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129 The Companies Act 2013, No. 18, Acts of Parliament, 2013 § 2(68) (India) (the nature of a private company requires that it restrict the right of shareholders to transfer shares).

130 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 §58(2) (India) ("[T]he securities or other interest of any member in a public company shall be freely transferrable."). *See also* Western Maharashtra Development Corp. Ltd. v Bajaj Auto Ltd., (2010) 154 Comp Cas (Bom.) 593 (India) (a preemptive right in a shareholders agreement of a public company is impermissible because it restricts the free transferability of the shares).

131 Messer Holdings Ltd. v. Shyam Madanmohan Ruia, (2010) 159 Comp Cas (Bom.) 29 (India).

132 Niranjan & Varottil, *supra* note 12 at 5-6, 8-9 (critiquing the lack of clarity in the state of the current law on the enforceability of agreements which impose limits on transferability under the Companies Act)

133 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 58(1) (India) (providing that a private company may restrict the transferability of its shares).

134 Messer Holdings Ltd. v. Shyam Madanmohan Ruia, (2010) 159 Comp Cas (Bom.) 29 (India).

135 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 58(1) (India).

c. Pre-emptive Rights

A right of first offer ("ROFO") requires that an investor who wants to sell their shareholding in the company must first make an invitation to offer to the promoter, who will have the option to make an offer for the shares.[136] If the investor accepts the offer made by the promoter, an agreement to sell the investor's shares to the promoter comes into being. If not, the investor will be free to sell his or her shares to a third party, but only for a higher price than was offered by the promoter and within a stipulated time period.[137]

We noted in the Articles of IHHR Hospitality Private Limited above that when the lock-in period was lifted for the investors, they would be free to sell their stock subject to a right of first refusal ("ROFR")—a variation of the ROFO. When shareholders agree on a ROFR arrangement, the selling shareholder (typically the investor) presents the offer made by a potential buyer of the shares, asking the promoters as to whether they would like to match the terms made by the potential third party buyer.[138] In other words, an offer is made by the investor to the promoters on the same terms as had been offered by the third-party buyer. If the promoter accepts the offer, an agreement to sell the investor's shares to the promoter comes into being. If not, the investor may sell its shares, but only to the identified third-party buyer and at the same terms as had been originally offered.[139]

It is important for the promoters to include a ROFO or a ROFR clause since it protects the ownership of the company against outsider influence. That prior to the investor selling its shares and bringing in a new partner, the promoters would have some opportunity to consolidate their shareholding or even ascertain who the potential partner in the form of the third-party buyer is, in the case of the ROFR. By and large, investors or selling shareholders prefer the ROFO. This is because when making an invitation to offer to third-party buyers, the selling shareholder must disclose that the other shareholders will have an opportunity to match the offer made by the third-party buyer. As a result, this may discourage the buyer

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136 Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *supra* note 13, at 1178.

137 *Id.*

138 David I. Walker, *Rethinking Rights of First Refusal*, 5 STAN. J.L. BUS. & FIN. 1, 9 (1999)

139 *Id.*

from expending the transaction costs necessary to make a firm offer.[140]

Whether to include a ROFO or a ROFR clause eventually comes down to the preference of the parties to the agreement and is dependent upon a number of factors, including the negotiating skills and bargaining position of each party. The question arises as to whether these processes, privately arranged between the shareholders, for the sale of shares at a later date, would be enforceable in a court of law.

We have seen in the previous section that the provisions of the ICA 2013,[141] when read with *Messer Holdings*,[142] allow parties to restrict the transferability of shares in private companies, but only when the restriction is mentioned in the Articles. A ROFO or a ROFR clause does not amount to a full restriction, as in the case of a lock in, but it does amount to a partial restriction in the sense that an investor will not be able to transfer its shares without an additional contractual hurdle to cross.

Thus, as far as transfers of shares are subject to a ROFO or a ROFR clause, providing these restrictions are mentioned in the Articles, the board must necessarily enforce these restrictions under Section 58(1) of the ICA 2013.

d. Exit Rights

One of the driving factors of PE investment into unlisted companies is the eventual aim of having the company make an initial public offering, creating opportunities for the investor to sell its shares either through an IPO or through secondary market transactions. However, depending upon market conditions and other factors, a public offering may not always be possible, and investors will seek to exit the company in any case.[143] One

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[140] *See* Corp. L. Comm. of the Ass'n of the Bar of the City of New York, *supra* note 13, at 1178 (explaining the difference between a right of first refusal and the right of first offer).

[141] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 58(3) (India).

[142] Messer Holdings Ltd. & Ors. v. Shyam Madanmohan Ruia, (2010) 159 Comp Cas (Bom.) 29 (India).

[143] *See* Umakanth Varottil, *Investment Agreements in India: Is there an "Option"?*, 4 NUJS L. REV. 467, 469 (2011) (explaining that put and call options in investment agreements often serve as exit opportunities for investors in case a public offering and listing of shares is impossible).

mechanism used by investors globally is to have the company buy back shares from the investor.[144] However, a buyback of shares under Indian law is considerably onerous and may be undertaken in only specified circumstances.[145] Thus, investors may insist upon a clause requiring the promoters to purchase the investor's shares upon the happening of a particular event or upon the expiry of a time period. This is known as a put option.[146]

For example, when Om Logistics Limited received an investment of USD 20 million from Newquest in December 2007,[147] the investor required that a put option clause be inserted into the Articles of the company.[148] This clause provided the investors with the right to require the promoters to purchase all the shares held by the investor in the event that there had been no initial public offering within 4 years and 1 month of the investment closing date.[149] The option further provided that the shares would be purchased at a price[150] providing an internal rate of return of 25% over the amounts invested.[151]

While there is little concern over the enforceability of the transfer of shares, there may be some concern over the fixed rate of return or assured return that the Articles of Om Logistics seem to give Newquest.

An investment by venture capital investors in India is considered a capital account transaction to be regulated by Foreign Exchange Management (Transfer or Issue of Security by a Person

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144 *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 339, 348-50 (2005) (discussing various contractual strategies employed by venture capitalists to ensure a method to exit their investment including redemption rights which obligate the company to buy back the venture capitalists' shares).

145 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 68 (India).

146 *See* Smith, *supra* note 144, at 349 (discussing the role of put options as exit opportunities).

147 *See Om Logistics raises Rs 120cr from Merrill Lynch*, NSEGUIDE (Jan. 18, 2008), https://nseguide.com/press-releases/om-logistics-raises-rs-120cr-from-merrill-lynch/ [https://perma.cc/8ZLW-BPPB] (reporting on Om Logistics raising 1.2 billion rupees in debt and equity with Merrill Lynch).

148 *See* Om Logistics Ltd., *Articles of Association*, MINISTRY OF CORP. AFF., GOV'T INDIA, art. 147 (II)(B) (listing the company's investor put option rights).

149 *Id.*

150 Commonly referred to as a Put Option Strike Price.

151 Om Logistics Ltd., *supra* note 148, art. 147 (II)(B)(d).

Resident Outside India) Regulations.[152] These regulations proscribe assured returns on investments[153] and prescribe share pricing methods[154] in case of foreign venture capital or private equity investments into India.

The regulations enable put options but not at a pre-determined price.[155] The regulations further elaborate on the pricing mechanism to be used to deduce the share price. In case of an unlisted company, the exit price can be arrived at as per any internationally accepted pricing method as long as it is duly certified at an arm's-length basis by a Chartered Accountant, a Securities and Exchange Board of India registered Merchant Banker, or a practicing Cost Accountant.[156]

The prohibition on having an assured return as part of a put option was brought to light in two recent judgments. In *Cruz City 1 Mauritius Holdings v. Unitech Ltd.*,[157] the parties and their subsidiaries had entered into various agreements for investment in real estate projects in India. Due to delay on the part of Unitech, Cruz City exercised its put option which required Unitech's subsidiaries to purchase its shares.[158] The Delhi High Court held that the put option was enforceable.[159] The argument that the assured return clauses are not enforceable was not accepted on the ground that the assured return was not absolute and unconditional.[160] The option could only be exercised within a specified time and was contingent on the delay in commencement of the project. Further the Court drew a distinction between assured return as proscribed by RBI and damages for a breach of contract.[161] The Court held that the investor was entitled to its remedies which included damages.[162] Similarly, in *NTT Docomo Inc. v. Tata Sons*

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152 *See* Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 (India) https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11253&Mode=0 [https://perma.cc/7NJM-944W] (listing the Act's definitions).

153 *Id.* § 10(7).

154 *Id.* § 11(3).

155 *Id.* § 2(v) Explanation a.

156 *Id.* § 11(3)(c).

157 (2017) 239 DLT 649 (India).

158 *Id.* para. 3.7.

159 *Id.* para. 124.

160 *Id.* para. 122.

161 *Id.* para. 120.

162 *Id.*

Ltd.,[163] if Tata Teleservices Limited failed to achieve certain performance targets as in the SHA then Docomo could request Tata to find a buyer for its stake or Tata could acquire the shares at the fair market price. The guiding principle was argued to be that the non-resident investor is not guaranteed any assured exit price at the time of making investment and shall have to exit at the price prevailing at the time of exit.[164] The issue came up before the Delhi High Court and was ruled in favour of the parties. The Court held the enforceability of the provision of the SHA under the terms of FEMA to be in the nature of downside protection on Docomo's investment and not assured return.[165] The judgment further clarified that the award to Docomo were damages for breach of the SHA and not the purchase price of the shares.[166]

Thus, it is clear that courts will uphold put options, they will also enforce the RBI ban on assured returns on put options, instead opining that investors may claim damages due to delays or other lacunae on part of the Indian party. It is therefore not unusual to see alternative mechanisms within Articles, which seem to have the same effect as having a put option with an assured return. For example, the Articles of Om Logistics go on to provide that in the event that the Put Option Strike Price is greater than the maximum allowable price under the FEMA pricing guidelines, then the promoters agree to pay the difference in the form of liquidated damages.[167]

The reverse of the put option is the call option, i.e. the right to require a shareholder to sell their shares to other shareholders.[168] However, call options are rarely seen in PE or VC investment agreements, instead they are more prominent in joint venture and acquisition agreements where acquirers take a controlling interest and play a role in the day to day management of the target company.[169] In any case, call options would amount to a partial restriction on the transferability of shares and due to the operation of Section 58 of the ICA 2013, read with Messer Holdings, the same would be enforceable.

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[163] (2017) 241 DLT 65 (India).

[164] *Id*. para. 48.

[165] *Id*. para. 58.

[166] *Id*. para. 49-50.

[167] Om Logistics Ltd., *supra* note 148, art. 147 (II)(B).

[168] Majumdar, *supra* note 45, at 87-89.

[169] Varottil, *supra* note 143, at 470.

An exit by way of an initial public offering ("IPO") is seen to be an ideal for venture capital and PE funds alike.[170] Investment agreements and therefore Articles will typically contain clauses which require the company and/or promoter to undertake an IPO within a stipulated period of time.[171] Such clauses may also include the right of the investor to select a merchant bank, to require that the investor shares be sold first and at a price amenable to the investor, thus making it a qualified IPO ("QIPO").[172] For example, Guayama P.R. Holdings B.V. (a subsidiary fund of GE Capital) invested USD 42 million in Gati Infrastructure for a 49.44% stake in July 2013.[173] As part of this investment, Guayama P.R. Holdings required that Gati Infrastructure or its parent company, Amrit Jal Ventures Limited, carry out an IPO within three years of the investment.[174] The clause further allows the investor a number of rights which include (*inter alia*): (i) the right to offer its shares to be sold as part of the IPO; (ii) the right not to be named as promoter and that no shares of the investor shall be locked in post the IPO; (iii) that the company shall not carry out an IPO if the minimum exit return required by the investor is not met; and, (iv) key matters such as preparation of the offer document, the stock exchanges on which the shares of the Company shall be listed, the advisors in relation to the IPO (including the investment bankers, underwriters, book-running lead managers and legal counsel) and their terms of appointment and pricing of the IPO shall be decided in consultation and agreement

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[170] *See* Smith, *supra* note 144, at 356 ("substantial evidence suggests that that the greatest financial returns are to be found in exiting into the public capital markets.").

[171] *See id.* at 353 (explaining that demand rights provisions in investment contracts sometimes stipulate that firms must register shares within a certain period of time from the signing of the investment contract or from the date of the IPO). *See also* Erik Berglof, *A Control Theory of Venture Capital Finance*, 10 J. L., ECON., & ORG. 247, 266 (1994) (discussing how venture capital agreements will stipulate procedures for future exit opportunities like IPOs).

[172] *See, e.g.*, Gati Infrastructure, *Articles of Association*, art. 166, MINISTRY OF CORP. AFF., GOV'T INDIA, at 57-58 (stipulating that in the event of an IPO, many material decisions relating to the transaction including the selection of the investment bank underwriter, the price, etc. must be made in consultation with the investor).

[173] *See generally GE Energy Financial Invests Rs 257 Cr in Gati's Sikkim Hydel Project*, HINDU BUS. LINE (Jul. 30, 2013), https://www.thehindubusinessline.com/companies/ge-energy-financial-invests-rs-257-cr-in-gatis-sikkim-hydel-project/article23116745.ece [https://perma.cc/TDC6-CR3G] (providing a broad overview of an energy project that GE invested in).

[174] Gati Infrastructure, *supra* note 172, at 55.

with the investor. Similar provisions are included in the event the parent company undertakes an IPO, in which case shares in the parent company would be swapped for the shares held by the investor. In the event that neither company undertakes an IPO, the company and its parent would be required to undertake an auction of the investor's shares. Each of these three events is referred to as a liquidity event.[175]

The provisions of this QIPO clause are exceedingly problematic and it is unlikely that such a clause will be enforceable. There are two main causes of concern.

The first is the non-classification of the investor as a "promoter." The ICDR 2018 defines the term "promoter" as a person "who has control over the affairs of the issuer, directly or indirectly whether as a shareholder, director or otherwise."[176] The definition further provides that a venture capital fund, alternative investment fund or a foreign venture capital investor "shall not be deemed to be a promoter merely by virtue of the fact that twenty per cent or more of the equity share capital of the issuer is held by such person unless such person satisfy other requirements prescribed under these regulations."[177] Therefore, a PE fund would not be classified as a promoter by mere virtue of its shareholding. However, there remains the issue of "control." The term "control" is defined as the "right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner."[178]

Given that an investor will typically have other rights such as the right to appoint directors, quorum rights, and most importantly, affirmative voting rights which give it some element of control over the management and policy decisions of the company, the question of whether such rights would amount to control has been repeatedly asked at the policy making and judicial levels to little avail. In the

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175 All of these conditions are stipulated in Gati Infrastructure's Articles of Association. *See id.* at 55-61.

176 ICDR 2018, *supra* note 122, at § 2(oo)(ii).

177 *Id.* § 2(oo)(iii).

178 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 2(27) (India). *See also* Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regulation no. 2(e), Gazette of India, pt. III sec. 4 (Sept. 23, 2011).

matter of *Subhkam Ventures v. Securities & Exchange Board of India*,[179] the Securities Appellate Tribunal (SAT) took the view that having the right to appoint a board member and affirmative voting rights was insufficient to constitute control and that these provisions were in the nature of protective rights as opposed to control rights. When the matter was escalated, the Supreme Court refused to address the issue of what would constitute "control," holding instead that the question of law was to be kept open for the time being and that the order of the SAT was not to be used as a precedent.[180] This turn of events came as a surprise to the investing community who were looking forward to a narrow definition of the term "control."[181]

In 2016, SEBI released a Discussion Paper on "Brightline Tests for Acquisition of 'Control' under SEBI Takeover Regulations"[182] wherein it suggested that appointment rights and affirmative voting rights in matters that are not part of the ordinary course of business or involve governance issues would not amount to control.[183] However, no further action has been taken on the said discussion paper. A similar stance was adopted in the matter of Clearwater Capital and Kamat Hotels in which SEBI took the view that covenants in an investment agreement between the two parties were of the nature of protective rights, rather policies under which to run the company.[184] However, in the absence of a clear indication from SEBI or the judiciary, that affirmative voting rights do not amount to control, and with the present definition of "control" in the ICA 2013, it would be difficult to take the view that investors with

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179 Securities Appellate Tribunal Order (Jan. 15, 2010) (India), available at http://www.sebi.gov.in/satorders/subhkamventures.pdf [https://perma.cc/8PL3-5VNJ].

180 Securities & Exchange Board of India v. Subhkam Ventures Pvt. Ltd., MANU/SC/1587/2011 (India).

181 *See generally* Umakanth Varottil, *The Nature of the Market for Corporate Control in India*, *in* COMPARATIVE TAKEOVER REGULATION: GLOBAL AND ASIAN PERSPECTIVES 344 (Umakanth Varottil & Wai Yee Wan eds., Cambridge Univ. Press, 2017) (analyzing takeover regulation in India).

182 SEC. & EXCH. BD. INDIA, *Discussion Paper on "Brightline Tests for Acquisition of 'Control' under SEBI Takeover Regulations"*, https://www.sebi.gov.in/reports/reports/mar-2016/discussion-paper-on-brightline-tests-for-acquisition-of-control-under-sebi-takeover-regulations_31883.html [https://perma.cc/97CT-VYJL].

183 *Id.* at 6.

184 SEC. & EXCH. BD. INDIA, Order in the matter of Kamat Hotels (India) Ltd., WTM/GM/EFD/DRAIII/20/MAR/2017 (Mar. 31, 2017), https://www.sebi.gov.in/sebi_data/attachdocs/1491380833690.pdf [https://perma.cc/Z9KH-8HKG].

affirmative voting rights which involve policy decisions of the company do not amount to control.

The second cause of concern in a QIPO clause is the question of whether an investor may be involved in matters relating to pricing. The ICDR 2018 stipulates that the issuer, in consultation with the lead manager may decide the price of the offering.[185] An investor by itself does not have any statutory authority or obligation to affect the pricing of the IPO. The investor in this scenario, as a shareholder of the issuer, is only part of such an issuer. However, an investor might possibly affect the price of the equity shares (or other securities) through either of the following mechanisms.

If the investor owns 26% or more of the company's shares, they can block special resolutions.[186] This is significant as Section 62(1)(c) of the Companies Act, 2013 mandates that the further issue of share capital to any person should be authorized by special resolution.[187] Should the price per share be unacceptable to the investor, they can simply block the special resolution.[188] Through this understanding of control (that control is exercised by denial of the resolution) the investor is able to 'affect' the price—even if they are not necessarily determining it at the first instance.

Should the investor hold less than 26% of the shareholding, they may control the pricing by negotiating an affirmative voting right on the pricing of the IPO or any fresh issue of shares. However, as mentioned elsewhere in this paper, the enforceability of such an affirmative voting right remains uncertain.

e. Preferred Payout on Liquidation

As opposed to a more generic liquidity event, which encompasses a number of corporate actions, it is not unusual for PE funds to seek a right to have their investment returned to them, with or without a return on investment, upon the liquidation of the company.[189] Liquidation preference is typically defined as the right

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185 ICDR 2018, *supra* note 122, at § 28.

186 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 114(2) (India).

187 *Id.* § 62(1)(c).

188 *Id.*

189 Swaraj Singh Dhanjal, *Venture Capitalists Add Tough Riders to Fund-Raising Pacts*, LIVEMINT (Nov. 17, 2015),

of the investor (usually holding preference shares), to receive its investment amount plus certain agreed percentage of the proceeds in the event of a 'liquidation' of the company, in preference over the other shareholders.[190] This is the only right that, in effect, converts the equity shares subscribed to by the PE into a preference share. Preference shares receive dividends and liquidation proceeds in priority over equity shares.[191]

The ordering of payouts upon the liquidation of a company is well settled in the law of insolvency in India. Section 53 of the Insolvency and Bankruptcy Code sets out the order of priority of distribution of assets for a company undergoing litigation.[192] Specifically, any contractual arrangement which disrupts the order of priority are to be disregarded by the liquidator.[193] Therefore, any clause in the Articles which gives the investor a preferred payout in priority over creditors, workmen, government dues or other preferential payments will not be upheld.

However, a question may be raised as to whether a liquidation preference between two shareholders holding the same class of shares may be enforced. The Insolvency and Bankruptcy Code also suggests that "at each stage of the distribution of proceeds in respect of a class of recipients that rank equally, each of the debts will either be paid in full, or will be paid in equal proportion within the same class of recipients, if the proceeds are insufficient to meet the debts in full."[194]

The answer to this may be found in a combination of repealed provisions between the erstwhile Companies Act 1956, the present Act of 2013, and the Insolvency and Bankruptcy Code. In cases of

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https://www.livemint.com/Companies/ZdXnzJzgvmZ09EJsPTo1SN/Venture-capitalists-add-tough-riders-to-fundraising-pacts.html [https://perma.cc/J7D6-ANQX].

190 Amrita Singh & Siddharth Shah, *Liquidation Preference: Get Your Basics Right*, ECON. TIMES MUMBAI (Jul. 22, 2008) http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Liquidation_preference_-_Get_your_basics_right.pdf [https://perma.cc/2XSF-68SU]. *See also* YATES & HINCHLIFFE, *supra* note 67, at 144 (discussing liquidation preferences in favor of private equity investors).

191 Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1171 (2013). *See also* The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 43 (India).

192 The Indian Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016 (India), § 53.

193 *Id.* § 53(2).

194 *Id.* § 53 (Explanation).

voluntary winding up,[195] the 1956 Act enabled the assets of a company to be divided amongst shareholders according to their rights and interests in the company, subject to the provisions relating to preferential payments and satisfaction of liabilities in full.[196] However, this provision was also made subject to the articles of the company as was upheld in *Globe United Engineering & Foundry v. Industrial Finance Corporation of India.*[197] Effectively, the articles could order the priority of payments to shareholders, as long as the company's liabilities and preferential payments had been satisfied. A similar provision existed in the 2013 Act as well.[198] However, with the enactment of the Insolvency and Bankruptcy Code in 2016, Section 320 of the Companies Act, 2013 along with the law related to voluntary liquidation has since been repealed.[199]

The present law on voluntary liquidation is found in Chapter V of the Insolvency and Bankruptcy Code (IBC). By virtue of Section 59(6) of the IBC, payments must be made in the same order of priority as is applicable to compulsory liquidation.[200] Additionally, in 2017, the Insolvency and Bankruptcy Board of India (Voluntary Liquidation Process) Regulations, 2017 were passed, which are applicable to the voluntary liquidation of corporate persons.[201] Notably, the provisions relating to Section 320 of the Companies Act, 2013 are absent.[202]

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[195] The Companies Act, 1956, No. 1, Acts of Parliament, 1956, § 510 (India). ("Provisions Applicable to Every Voluntary Winding Up").

[196] *Id.* § 511 ("Subject to the provisions of this Act as to preferential payments, the assets of a company shall, on its winding up, be applied in satisfaction of its liabilities pari passu and, subject to such application, shall, unless the articles otherwise provide, be distributed among the members according to their rights and interests in the company").

[197] (1974) 44 Comp Cas (Del.) 347 (1973) (India).

[198] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 320 (India).

[199] The Indian Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016 (India), Schedule 11.

[200] *Id. §* 59(6).

[201] *See* The Insolvency and Bankruptcy Board of India (Voluntary Liquidation Process) Regulations, 2017, § 1(3) (India), available at https://ibbi.gov.in/IBBI%20(Voluntary%20Liquidation)%20Regulations%202017.pdf (listing the applicability of the Regulations) [https://perma.cc/J94E-76NC].

[202] *See* The Indian Insolvency and Bankruptcy Code, 2016, No. 31, Acts of Parliament, 2016 § 255 and the Eleventh Schedule, Clause 16 (India), available at https://ibbi.gov.in/IBBI%20(Voluntary%20Liquidation)%20Regulations%202017.pdf [https://perma.cc/A73K-65PB] (repealing Section 320 of the Indian Companies Act 2013).

Two observations may be made from these developments. First, in the case of voluntary winding up, shareholders would have been able to create an order of priority amongst themselves, which, if present in the Articles, would have been upheld by the liquidator or court due to an enabling provision in both the 1956 and 2013 Acts. That position has changed in 2017 with the removal of the enabling provision.

Second, there is no corresponding provision for companies under compulsory liquidation which would enable shareholders to privately order priority of payments amongst themselves. In fact, the IBC clearly suggests that recipients of a class that rank equally will be paid in full or in proportion and that any agreement which disrupts the order of priority will be disregarded.[203] If equity shareholders are considered a class that rank equally, then in the absence of an enabling provision which allows for the private ordering of priority payments amongst them, a clause suggesting liquidation preference would not be upheld.

Practitioners have long suggested that the enforcement of liquidation preference rights is subject to the interpretation of the courts, having been "imported" through practice.[204] As noted above, in the absence of a provision that specifically allows a shareholder to enforce a liquidation preference, the same ought not to be included in the SHA or the Articles. As a result, suggestions have also been made to protect equity or convertible investments through a combination of other rights including put options, drag and tag along rights.[205] Additionally, the ICA 2013[206] read with the Companies (Share Capital and Debenture) Rules[207] allow for the creation of classes of equity shares with different rights provided the articles of the Company authorize them to do so. As a result, investors may also consider negotiating for preference shares, or a class of shares separate from those of promoters or setting up an exit mechanism prior to actual liquidation. However, an equity shareholder cannot be better placed than a preference shareholder,

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203 *Id.* § 53.

204 Ajay Joseph, *Can liquidation preference be enforced in India?*, VCCIRCLE (May 24, 2016), https://www.vccircle.com/can-liquidation-preference-be-enforced-india [https://perma.cc/QX64-8LH7].

205 Singh & Shah, *supra* note 190.

206 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 43(a)(2) (India).

207 Companies (Share Capital and Debenture) Rules, 2014, Securities and Exchange Board of India, § 4.

or any other group of stakeholder's that fall before equity shareholders in the waterfall mechanism provided by Section 53(1).[208] Secondly, the Act does not authorise the creation of different classes of preference shares and hence, one preference shareholder cannot be at a more beneficial position than any other preference shareholder. Such an act could be deemed repugnant to the ICA 2013.[209]

4. CONCLUSION

Private equity and venture capital investments are critical to the promotion of entrepreneurship and the growth of startups. In exchange for investments, these funds take up equity positions and share in the risks and rewards in their investee companies. In the Indian context, where concentrated shareholding in the hands of the founder or promoter is the norm, PE and VC funds typically take up a minority position. In order to protect themselves from the self-opportunism of promoters, such investors also negotiate for special rights as part of the investment. These rights are crystallised into an agreement between the investor, promoter and the investee company and by the passage of law, and must be included in the Articles of Association of the investee company.

This paper highlights the various rights that are typically negotiated by investors. Broadly, I have divided these rights into two categories. The first are governance rights, which help an investor keep an eye on the inner workings of the company and to ensure that the company uses the invested funds for the proposed purpose. The second category includes full or partial restrictions on the transfer of shares as a protection to the investor against loss in shareholder value.

The issue arises with the treatment of these rights before the Indian courts. With inordinate delays with the Indian judiciary, most disputes involving PE and VC investments are either settled out of court or are arbitrated upon.[210] In either case, the outcome of the dispute resolution process is unknown. Using the scant case law available and relevant provisions of company and securities law in

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[208] The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 53(1) (India).

[209] *Id.* § 6.

[210] Vijay Sambamurthi, *Recent Developments in Indian Law: Impact on Private Equity Transactions*, 28 NAT'L L. SCH. INDIA REV. 44, 57-58 (2016).

India, we have seen how these rights may be treated, should their enforceability ever come into question.

Courts will uphold the appointment of specific people as directors on the board of the company[211] and will uphold higher quorum requirements than those required in the ICA 2013.[212] However, it is not certain as to whether courts will uphold the requirement of a specific representative to be present at a meeting for the meeting to be quorate. Certain affirmative voting rights such as those that require a higher standard to be met in order to alter the Articles or those that deal with matters which are typically dealt with at the Board level may be upheld. However, the same cannot be said for matters that require a members' resolution. Investors may require higher standards of information rights, for example, and it is unclear whether this type of provision would be upheld.

Through the examination of case law relating to how a company is governed and managed, it seems that courts will, in general, apply corporate law and norms as a set of standards to be maintained. These standards are highlighted in the ICA 2013 and elsewhere as to the minimum requirements for a company to carry out its activities. There is enough literature to show that corporate law is applied as a set of standards elsewhere in the world as well.[213] It may be then argued that while the ICA 2013 contains the minimum standards to be met for a company to carry out its activities, the company and its constituent elements, including the directors and the shareholders may hold themselves to a higher standard. These higher standards must be recorded for reference purposes and where better to record these higher standards than the Articles of the company? Given that the Articles are publicly available documents, it stands to conventional wisdom that a third party engaging with the company or its constituent elements are made aware of the higher standards that the company holds itself to. As a result, if we were to view the gamut of company law as a set of standards that companies have to

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211 The Companies Act, 2013, No. 18, Acts of Parliament, 2013 § 149(7)(Explanation), §161 (India).

212 *Id.* §103; The Companies Act, 1956, No. 1, Acts of Parliament, 1956, § 174 (India). *See also* In Re: Subhiksha Trading Services Limited, (2011) 161 Comp Cas (Mad.) 454 (India) (holding that an increased quorum is not violative of Section 9 of the ICA 1956).

213 *See, e.g.*, John Armour, Henry Hansmann, & Reinier Kraakman, *Agency Problems, Legal Strategies And Enforcement in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 29 (Reinier Kraakman et al. eds., 2004); Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993).

meet, there seems to be no reason why courts will not uphold a higher set of standards.

In terms of shareholder value protection, the ICA 2013, when read with a number of case law relating to how transfers of shares may be restricted, allows for a wide variety of full and partial restraint of transfers. While matters relating to further fundraising or share transferability are well settled, the same cannot be said for preferential payouts on liquidation of the company, particularly under the Insolvency and Bankruptcy Code.

While legislators have transplanted corporate governance norms from other parts of the world with varying degrees of success,[214] it seems that corporate law practitioners aren't far behind. A large number of these clauses that are negotiated on behalf of investors seem to emanate from accepted principles of corporation law in the United States. However, there is little or no reason to believe that any or all of those clauses would be accepted as enforceable under Indian law. Therefore, practitioners ought to exercise caution before transplanting clauses that are seemingly conventional elsewhere but may not find the same acceptance before Indian courts.

In this paper, I sought to doctrinally analyse the enforceability of clauses typically found in PE and VC transactions in India. In terms of future research, this paper could be the foundation for empirical studies for PE and VC protection in India and comparative studies for the same elsewhere in the world. Future research could also question whether restrictions on the governance of companies and transferability of shares affects the ease of doing business for startups and young companies or even amounts to a restraint of trade. It is hoped that this paper marks the beginning of a more sophisticated approach towards PE and VC funding in India.

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214 Varottil, *supra* note 7.