Private Equity Transaction in India

Ved Prakash
PRIVATE EQUITY TRANSACTION IN INDIA

Ved Prakash

Private equity has grown substantially in recent years and private equity players, venture players, and foreign investors, invested in India, have immensely benefited in recent years. Yet, the potential for further investment and expansion in India is enormous. Investment in the emerging industry in India can guarantee superior returns, as India’s economy is gradually catching up with global needs and has vast pool of intellectual and efficient private owner. India’s policy have guaranteed a stable legal and regulatory environment, liberal policies towards private enterprises, sound financial systems, market opportunities, appetite for entrepreneurship. Typically, Investors have immensely benefited with service sectors in information technology and business process outsourcing. Having a pool of educated and huge population gives advantage to the investor to invest in India. This has been a trusted route for investor to make money. Of all available routes to investors, they have realized that the most important route is value creation by active ownership. A private equity player involves in various aspects of project financing, real estate financing, investment companies and special vehicle purpose established for the purpose of offering financing to investors and equity interest in secondary market. Private equity is an attractive source of funding for start-up companies, operating private companies seeking to expand their operation to as a bigger market. Private equity is also useful for company who do not wish to avail the financing from Banks or financial institutions, or alter its ownership structure.

In a typical private equity transaction, the documents negotiated and executed is share-purchase, share-sale or shareholders’ agreement. Due to increased foreign equity participation and strong foreign investors being interested in Indian company, often complex documents are negotiated and executed. In most of cases, foreign investors use the services of experienced attorney of premier law firm, who negotiate the terms on behalf of Investors. India witness regular use of terms used in international transaction, which is still in initial stage of private equity investment. While usages of international terms and practice have a distinct advantage, understanding of such terms is precondition for any investors, which would have a significant impact in the time of difficulty or dead-lock. Therefore, private equity player should make themselves aware of the legal system and the regulatory compliances

* Ved Prakash, Lawyer. He can be reached at vpkehari@gmail.com.
in India. The important statutes require compliances for private equity investment in India are the Companies Act, 1956 (the “Act”), the Foreign Exchange Management Act, 2000 and the Securities and Exchange Board of India Act, 1992 along with the rules and regulation therein. It will be wise to take advice of the tax expert on the private equity transaction to minimize the tax incident in India.

A private equity transaction has three main stages – the angel funding stage, expansion stage and acquisition stage, depending upon the requirement of financing. The stages of private equity transaction are provided here.

1. angel funding stage:
   a. seed capital stage- initiate products or business idea.
   b. start-up stage- initiate marketing effort.
   c. early business stage- initiate and expand selling effort.

2. expansion stages:
   a. first stage- production and sales facilities.
   b. second stage- working capital, to expand operations to achieve full utilization.
   c. third stage- expansion and introduction of new facilities or products.
   d. fourth stage- prepare a company for going public or for strategic acquisition by a larger company.

3. acquisition/buyout financing stages:
   a. acquisition financing- investee company acquire another company.
   b. buyout financing- buy the entire investee company or buy the facilities related to specific product lines or specific business division from the investee company.

Typically, a private equity transaction is passes through various stages. These are provided here.

1. conceptualization, initial valuation, feasibility study of transaction
2. structuring and term sheet
3. due diligence
4. documentation and negotiation stage
5. funding and completion
6. portfolio management

The key documents of private equity transaction are provided here.

1. term sheet
2. subscription agreement
3. share purchase agreement
4. shareholders agreement
5. charter document (memorandum and articles of association)

A security forming the basis of a private equity transaction is provided here.

1. equity shares (comparable with the concept of common shares in the US)
2. convertible preference shares (comparable with the concept of convertible preferred shares in the US)
3. convertible debt and
4. warrants

1. **Equity Shares**

Although equity shares are not as popular as convertible preferred shares, private equity investors are still willing to acquire them in certain circumstances. For example, an investor with a longer time horizon and capital gain objectives may prefer the simplicity of an equity share investment, particularly in a middle-aged company with a stable earnings history. Equity shares will typically enjoy the benefits of a return on capital in the form of dividends, the right to vote and the upside on potential growth through the right to receive the remaining assets of a company on its liquidation, dissolution or winding up. It is possible to give differential rights as to dividend, voting or otherwise in accordance with the Act, and also an affirmative voting right in respect of material or reserved matters.

2. **Convertible Preference Shares**

Convertible Preference shares can offer considerable benefits to private equity investors over equity shares. The attributes of these preference shares could include the following:

a. a preferred return in the form of dividends (usually cumulative).
b. a preference on liquidation.
c. a right of conversion to equity shares to facilitate participation in liquidity transactions.

Preference share investments by private equity investors reliably provide for a preferential dividend. This could be a predetermined percentage of the paid-up or fixed amount. Such dividends are usually
cumulative in nature. This is significant to investor for simple reason even if future dividends are not anticipated; it will affect investors’ liquidation preference and conversion rights. Besides, the holders of Preference shares can enjoy right to participate with the holders of equity shares, usually on a pro-rata basis, on all dividends in excess of the aggregate preferred share dividend. Except in the situation of amalgamations or other transactions in which there is no effective change of control of the company, such as an amalgamation with a wholly-owned subsidiary, typically, private equity investors may insist upon provisions in the share conditions providing that an acquisition of the company will be deemed to be liquidation. It is notable that preference shareholders generally have a right to vote only on resolutions placed before the company which directly affect the rights attached to his preference shares†.

3. Convertible Debt

It is not uncommon for private equity investors to advance funds by way of secured, subordinated convertible debt in the form of debenture. The followings are advantages of debt financing:
   a. in a bankruptcy or insolvency scenario, a priority over all equity (Preference and equity) and, subject to certain exceptions, priority over unsecured creditors;
   b. priority return on investment through interest that is paid ahead of all dividends;
   c. security on the assets of the company;
   d. the right to convert into equity at the optimum time with the conversion price being protected for “event-based” and “price-based” anti-dilution; and
   e. potentially, debt on a demand basis, permitting a full return of the funds advanced on relatively short notice.

4. Warrants

Warrants are issued to private equity investors, as additional consideration. Warrants are essentially options to acquire equity shares, convertible Preference shares or other securities. In circumstances where a company is anticipating a new round of financing, it will often issue a warrant for the series to be issued in the next financing at the next-financing price per share, defaulting to the current preferred share price if the financing does not close within a reasonable period of time. The typical warrant term is five to ten years. There will often be provision for termination of the warrant upon an
amalgamation, merger or acquisition of the company or an IPO, since outstanding warrants are dilutive to potential investors.

An explanation of terms used in private equity transaction is provided here.

1. **Pre-emption rights:**

In a simple language, a pre-emption right is a right to acquire certain property in preference to any other person. It usually refers to property newly coming into existence. The most common form of pre-emption right is the right of existing shareholders to acquire newly issued shares issued by a company in a rights issue, usually but, not always in public offering. As per Act, this right is automatically provided for a public company, however for a private company, it only arises if provided for under the articles of association of the relevant company.

2. **Right of First Offer (Rofo) and Right of First Refusal (Rofr):**

Rofo is a contractual right that the seller must first give the rights holder the opportunity to purchase an asset, but does not set requirements for the transaction. The seller agrees to negotiate with the rights holder, and attempt to reach an agreement. If the seller and rights holder cannot reach an agreement, the seller may then negotiate with or sell to any other party. Rofr gives the holder the right to meet any other offer before the proposed contract is accepted. Rofr is a contractual right that gives its holder the option to enter a business transaction with the owner of something, according to specified terms, before the owner is entitled to enter into that transaction with a third party. In brief, Rofr is similar in concept to a call option. Rofr can cover almost any sort of asset, including real estate, personal property, a patent license, a screenplay, or an interest in a business. It might also cover business transactions that are not strictly assets, such as the right to enter a joint venture or distribution arrangement. Because a Rofr is a contract right, Rofr holder's remedies for breach are typically limited to recovery of damages. In other words, if the owner sells the asset to a third party without offering the holder the opportunity to purchase it first, the holder can then sue the owner for damages but may have a difficult time obtaining a court order to stop or reverse the sale. However, in some cases the option becomes a property right that may be used to invalidate an improper sale. An Rofr differs from a Rofo in that the Rofo merely obliges the owner to undergo exclusive good faith negotiations with the rights holder before negotiating with other parties. A Rofr is an option to enter a transaction on exact or
approximate transaction terms. A Rofo is merely an agreement to negotiate.

These terms are used in the context of exit by a party, that is, sale of shares by a shareholder in the company. Rofo essentially means that if a shareholder entity decides to sell its share in the company, the selling shareholder must first offer its shares to the other shareholder (to whom a Rofo is granted), who in turn may offer a price for the shares to the selling shareholder. If satisfied by the price offered by the other shareholder or if the selling shareholder is unable to obtain a higher price from a third party, then the selling shareholder entity only has the choice to sell its shares to the shareholder who has the Rofo right. However, if the selling shareholder receives a price higher than that offered by the other shareholder from a third party, the selling shareholder is free to sell shares to the third party at the higher price.

For instance, if there are two shareholders in a private company, say, X and Y, with a Rofo in favour of Y granted by X, and X decides to sell his shares, then X must first offer his shares to Y. Only if Y refuses to purchase X’s shares, or if X can obtain a higher price for his shares from a third party than that being offered by Y, can X sell his share to a third party.

On the other hand, if there is a Rofr in favour of Y, then X is first required to offer his share to third parties and obtain a price from them for this. X is then required to approach Y with the price offered by third parties. If Y can match or better the price offered by third parties, X require to sell his share to Y.

A Rofo in favour of the promoters could be a preferred choice for an investor seeking to exit a company, because a Rofo provides the investor a price with which to begin negotiations with third parties and the process of negotiating best price of shares remains in the investor’s hands. Whereas, if there is Rofr in favour of the promoters, no third party would be interested in the investor’s shares as even after discovering the price of investor’s shares by the third party, there remains a situation where sale will not eventually take place if the promoter matches the price offered by the third party.

Still, there are lots of variations to the above basic concept of Rofo or Rofr in practice.

3. Drag Along Right and Tag Along Right:
Drag along right is a legal concept in private equity transaction. This right assures when the majority shareholder sells his stake, minority holders are forced to join the deal. This right protects majority shareholders. This right is fairly common in the transaction document. This right terminates upon exit of right’s holder. The majority shareholder dragging should offer the minority shareholder the same price, terms, and conditions as offered to any other seller. Thus, drag along right achieves the idea of eliminating minority shareholders and selling 100% of a company’s shares to the new investor.

Whereas, tag along right help in protecting the rights of minority shareholders. If a majority shareholder sells his or her stake, then the minority shareholder has right to join the transaction and sell his or her minority stake in the company. A tag along right is very effective to oblige the majority shareholder to include the holdings of the minority shareholder in the negotiations in order to facilitate the possibility that a tag along right is exercised. Tag-along rights are usually exercised in the wake of a ROFO or ROFR as the result of which the shareholder would be left in a minority position.

In simple term, drag means if majority sell, minority will be required to sell with majority and tag means if majority sell, minority will have the right to sell along with majority.

Private equity investments usually have a timeframe within which the promoters agree to provide an exit for the investors on predefined terms. Drag along right in favour of the investors is useful in the event the promoters fail to agreed exit. A drag along right provides greater marketability for a new investor in the company. Similarly, tag along right in favour of the investors is useful in the event the promoters intend to sell their shares, in such case too, the investor can sell its share on terms similar to those offered to the promoters.

4. **Put Options and Call Options:**

A reference of the rights and obligations such as put options and call options is usually found in private equity transaction. In simple term a put option means that the option holder has the right to require the other party, namely the option grantor, to buy shares held by the option holder on the occurrence of certain events and on the basis of pre-agreed pricing formulas. In other words, the option grantor has obligation to buy the shares put to him by the option holder. Whereas, a call option gives the option holder a right to call on the option grantor to sell the shares held by the option grantor to the option
holder on the occurrence of certain events and again on the basis of pre-agreed pricing formulas. The option grantor has a binding obligation to sell his shares to the option holder on a call from the option holder.

In most of the times, the price for the shares is not agreed upon, but the pricing formulas or the basis of calculation of the exercise price of the option (based on fair market value, discounted future cash flows or other standard industry benchmarks). In addition, the put and call options can be securitised, with the option grantor providing appropriate security for the underlying options.

Put options are also viewed as providing exit routes to the investor under circumstances where the promoter fail to achieve other exit routes for an investor, such as public listing of the investee company through an initial public offering. Call options, among other measures, are also used by an investor to increase his stake in a company and get the benefit of pre-agreed pricing formulas.

In the event there is a default by a party under the transaction document, the rights under put and call options emerged as finest tools. The non-defaulting party may be given the right to put its shares to the defaulting party at a price which is above the fair market value of the securities concerned. Alternatively, the non-defaulting party may be given the right to call upon the defaulting party to purchase the shares of the defaulting party at a price which is below the fair market value of the securities concerned. Essentially, the right to put or call can be exercised by the non-defaulting party at his discretion, considering the market conditions and financial capabilities of the defaulting party.

Under India’s foreign exchange control regulations‡, there is a legal limitation for exercising put and call options, because of the statutory pricing norms applicable to a non-resident in respect of the purchase or sale of shares to an Indian resident.

If a non-resident investor seeks, under a put option exercised by it, to sell shares to an Indian resident, the sale price cannot exceed the fair value of shares determined under the pricing guidelines under the India’s foreign exchange regulations. At the same time, if a non-resident investor seeks, under a call option exercised by it, to buy shares from the Indian resident shareholder, the purchase price cannot be below the fair value of shares determined under the pricing guidelines under applicable foreign exchange regulations.
The parties, nevertheless, can explore approaching the Reserve Bank of India for specific approval for any transaction that they propose to conduct which is not in accordance with the pricing guidelines as per the regulations.

There is another issue because of conflicting view relating to the applicability of the Securities Contract (Regulation) Act, 1956 (SCRA) to put option or call option for an unlisted public company§. While SCRA is not applicable to a private limited company however, there is a separate regulation to govern agreements for the sale and purchase of listed company shares (such as takeover regulations). SCRA prohibit derivative or forward trading contracts except when made on a “spot delivery basis”. While there is a view is that put or call options may fall within the ambit of SCRA, others have a view that if the actual sale or purchase is being made on a spot delivery basis, the put option or call option are merely agreements to sell or purchase shares and, therefore, are outside the purview of SCRA.

5. Fully Diluted Basis:

On a fully diluted basis means that the equity base of the company is to be calculated assuming that all convertible instruments have been converted into equity. This gives an investor surety of equity percentage it will eventually hold in the company.

6. Registration Rights:

A shareholder agreement may provide a special feature involving private equity investors a registration or prospectus rights. These allow the shareholder to force a private company to go public or to force a public company to list the shares of private equity investors for trading after a given period of time in specified circumstances.

**Enforceability of rights available to shareholder under shareholders’ agreement and article of association**

Often the investor provide for the special provision in the article of association of the company or shareholders agreement or both, as the rights of the shareholders provided by the laws may not be appropriate for all situations. In context of enforceability of rights available to shareholder under shareholders’ agreement and article of association is provided here.

The articles of association primarily serve to govern the internal management and control of the company and are subject to memorandum of association of the company and the principle of company law lay down by the court. The Act overrides the memorandum, articles, agreement or resolution of the board of directors to the extent it is repugnant to the provision of the law.” Each shareholder is obliged to the company to comply with the articles in his capacity as a member.

2. Effect of Shareholders’ agreement.

While shareholders' agreements are enforceable in India to the extent it has been incorporated in the articles of association of the company. Thus, private documents are not enforceable to the company and its shareholders, unless incorporated in the articles. This legal position in India has been reiterated in a recent judgment††. The Indian Court has inclination in favour of articles of association and it is a settle principle that a restriction which is not specified in the articles of association is not binding either on the company or on the shareholders.

* * *

This paper is a copyright of Author. Author views represented here is purely personal. No reader should act on the basis of any statement contained herein without seeking professional advice. Author expressly disclaim all and any liability to any person who has read this paper, or otherwise, in respect of anything, and of consequence of anything done, or omitted to be done by any such person in reliance upon the contents of this paper. Author also expressly disclaims all warranties as to the accuracy, completeness or adequacy of such views. Author shall have no liability for errors, omissions or inadequacies in the information contained herein or for interpretations thereof.

* The rate of dividend payable to a foreign company on preference shares issued by an Indian company cannot exceed 300 basis points over the prime lending rate of the State Bank of India prevailing as on the date of the board meeting on which issue of preference shares was recommended. (Clause 7 of Schedule I of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000.

† Section 87 of the Act - Preference shareholders shall be entitled to vote on every resolution placed before the company at any meeting, if the dividend due on such capital or any part of such dividend has remained unpaid (i) in the case of cumulative preference shares, in respect of an aggregate period of not less than two years preceding the date of commencement of the meeting; and (ii) in the case of non-cumulative preference shares, either in respect of a period of not less than two years ending with the expiry of the financial year immediately preceding
the commencement of the meeting or in respect of an aggregate period of not less than three years comprised in the six years ending with the expiry of the financial year aforesaid.

‡ The Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, as amended from time to time. This is issued under the notification no.FE MA.20/2000-RB dated 3rd May 2000 by the Reserve Bank of India

§ Unlisted Public Company means a Public Company not listed with any recognised stock exchange. Under Companies Act, 1956, a public company means a company which (a) is not a private company; (b) has a minimum paid-up capital of INR. 500,000 or such higher paid-up capital, as may be prescribed; (c) is a private company which is a subsidiary of a company which is not a private company. A private company means a company which has a minimum paid-up capital of INR. 100,000 or such higher paid-up capital as may be prescribed, and by its articles, (a) restricts the right to transfer its shares, if any; (b) limits the number of its members to fifty not including - (i) persons who are in the employment of the company, and (ii) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased; and (c) prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company; (d) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives, provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this definition, be treated as a single member.

** Section 9 of the Act - Save as otherwise expressly provided in the Act -(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 (b) any provision contained in the memorandum, articles, agreement or resolution aforesaid shall, to the extent to which it is repugnant to the provisions of this Act, become or be void, as the case may be.

†† The Bombay High Court in IL & FS Trust Co Ltd v Birla Perucchini Ltd [2004]. Also, the Supreme Court in VB Rangaraj v VB Gopalakrishnan [1992].