Venture Capital and Private Equity Investment – Legal Considerations

The Chamber of Tax Consultants

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Unicorn Year

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 Confidential

Trends and Predictions

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India has seen significant growth in start-ups, VC / PE firms and investment

Impact of pandemic on PE and VC transactions

- Increased investment in stressed companies,
- Increased number in buy-outs,
- Increased numbers of investments by partners only,
- Increased investment in technology-driven industries and e-commerce/retail business.

India has a situation of over-supply capital

Trends and Predictions

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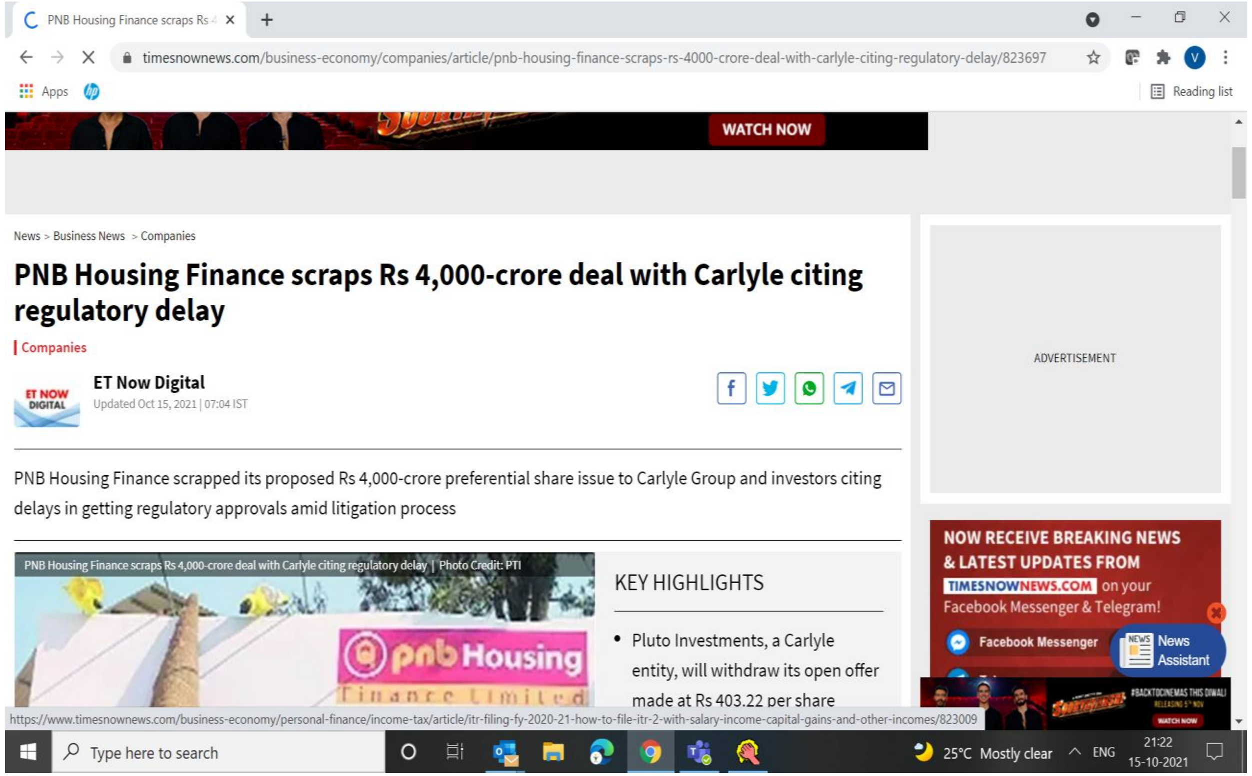

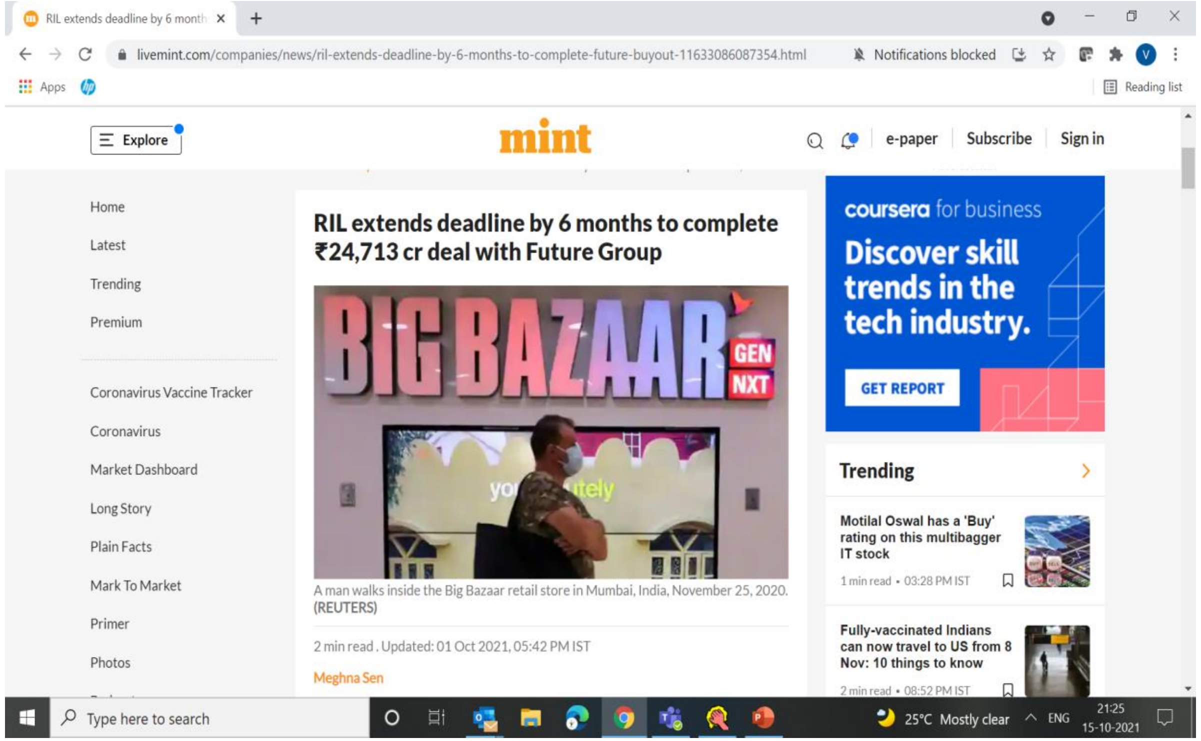

Trends and Predictions

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Developments in legal-framework in the recent times

- Conducting board meetings and shareholder’s meeting via video conference
- Relaxing the quorum requirements under Companies Act, 2013

Other Developments

- All foreign investors or beneficial owners of an investor residing in a country that shares a land border with India may invest in Indian companies only with prior governmental approval

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Private Equity and Venture Capital

Private Equity and Venture Capital

Key differences

- Target companies for investment
- Amount of investment
- % Stake acquired by investment
- Stage at which investment takes place

Private Equity and Venture Capital

Venture Capital

- fund and mentor start-ups
- funding in exchange for a minority stake of equity—less than 50% ownership

Private Equity

- Usually invest in established businesses that are deteriorating because of inefficiencies
- Often take a majority stake—50% ownership or more—in mature companies

How does Funding work?

POOLING OF FUNDS

GENERAL PARTNERS

LIMITED PARTNERS

Investment Process

Investment Process

Early on identify

- Primary goals of the Parties
- Alternatives to achieve primary goals
  - Satisfies as many of the primary objectives
- How to share risks

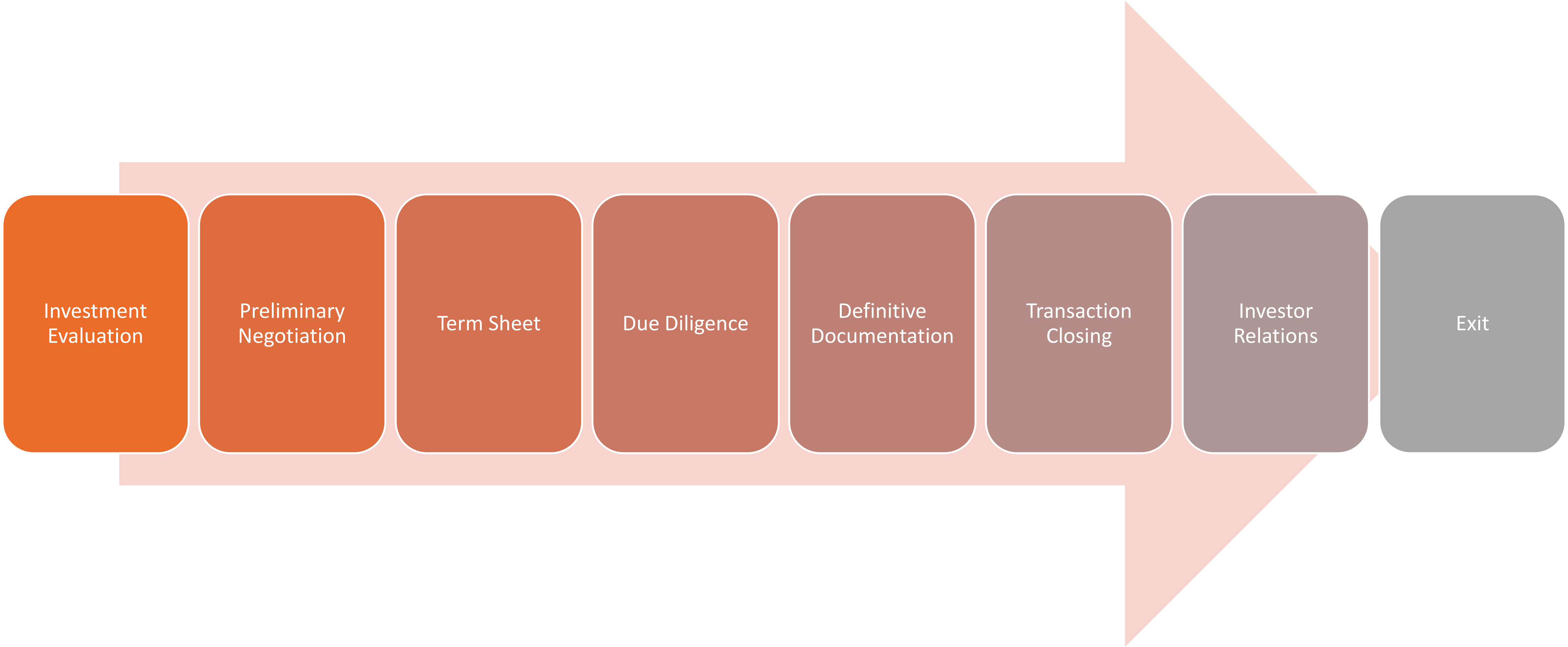
Investment Process (contd…)

This is all about Investee and Investor

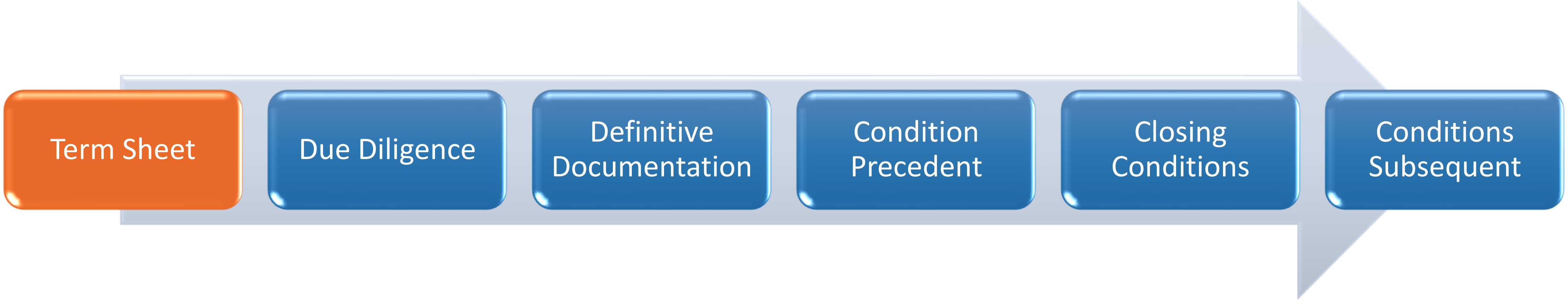
- At times financer
- Regulator
- And advisors

Need to create a win-win situation, else no deal, and no deal is a bad deal!!

Investment Process



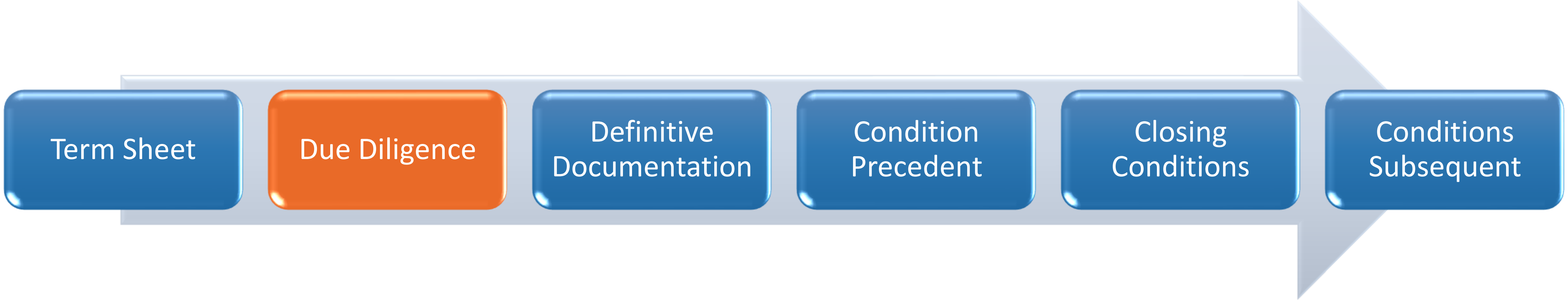
Term Sheet



- Term Sheet set out their commercial agreement or understanding of their respective rights and obligations in a non-binding term sheet or letter of intent

- Lays down the foundation and contours of the Transaction

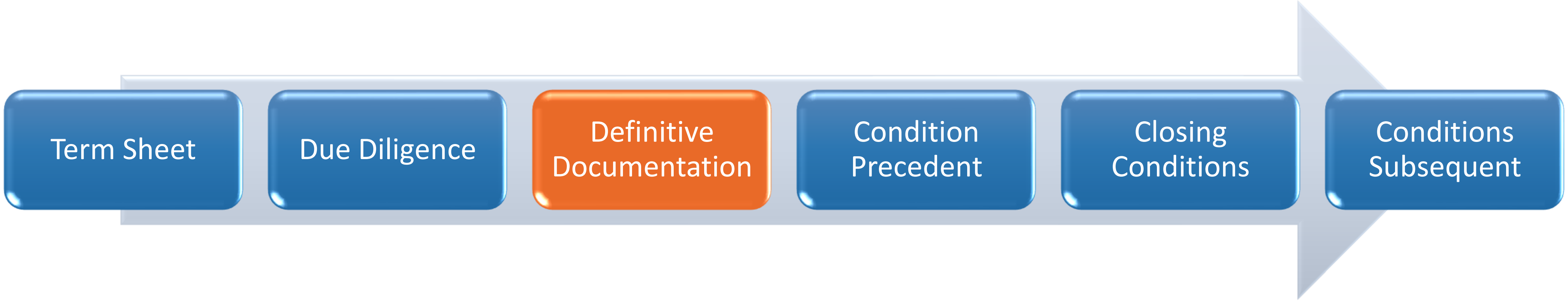
Due Diligence



- Due Diligence includes legal, HR, financial, taxation and business (and sometimes, an operations and technical) due diligence on the target

- Background check on the promoters of the target.

Definitive Documentation

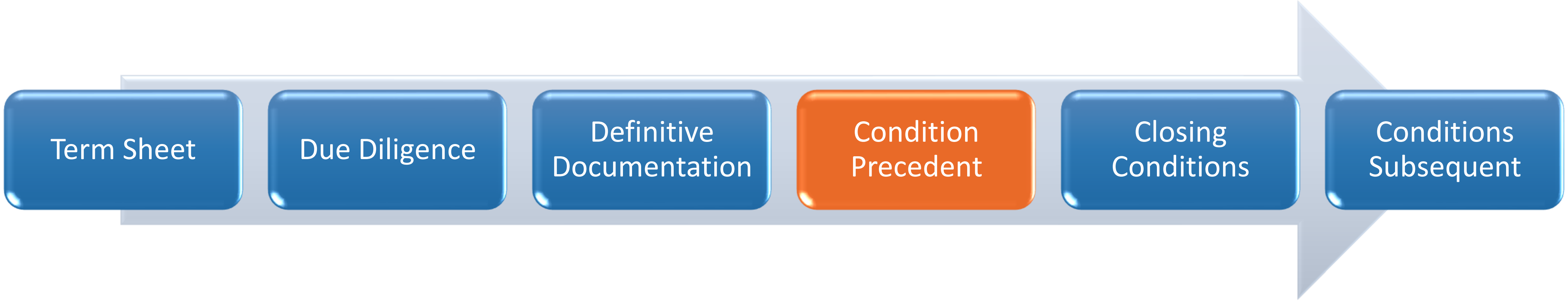


- Parties finalize investment agreements pursuant to the provisions of the term sheet, subject to any modification or negotiation of terms and conditions based on the due diligence reviews conducted by the investor(s).
- Usually includes:
  - Share subscription agreement (for a primary transaction)
  - Share purchase agreement (for a secondary transaction)
  - Shareholders' agreement (to govern the rights and obligations of the company and shareholders)
  - Promoters Employment Agreement

Disclosure Requirements

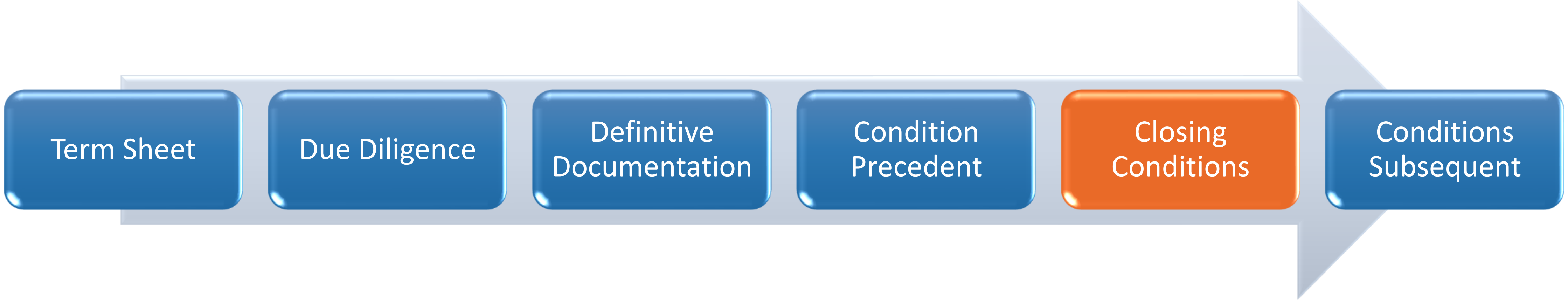
- Investor(s) seek a comprehensive set of representations and warranties from a target and its promoters (or, in case of a secondary transaction, from the target and its promoters, as well as the selling shareholders) in relation to
  - capacity to execute the investment agreements and complete the transactions contemplated therein
  - business warranties
  - corporate governance warranties
  - tax warranties
  - warranties in relation to litigation against or by the company
  - any other warranties that may be required from the target in relation to its business or the type of industry in which it is involved

Conditions Precedent



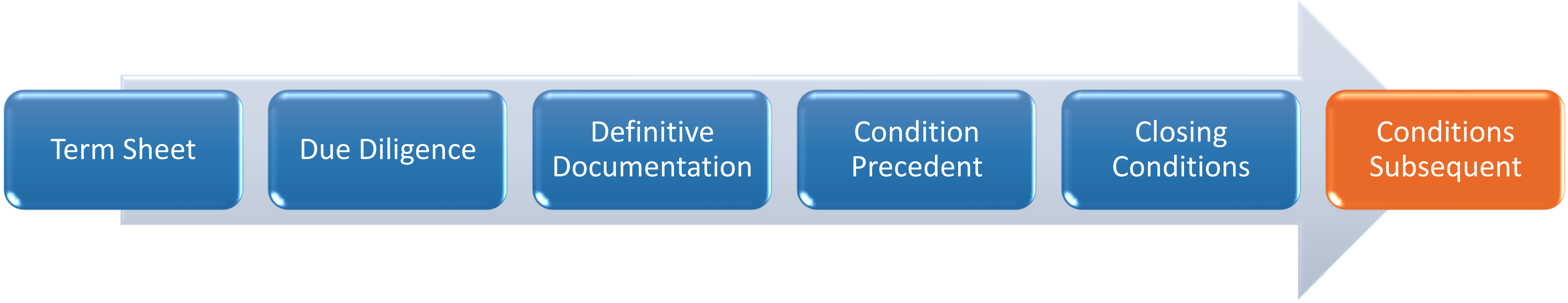
- Findings from the due diligence are incorporated into the investment agreements as conditions precedent or requisite indemnities, depending on:
  - the nature of the issues raised by the due diligence;
  - the timelines required or envisaged to complete the deal;
  - the action items to comply with to remedy any particular issues; and
  - the commercial understanding between the parties.

Closing Actions



- Subject to the conditions precedent to the investment transaction being complete or waived by the investor(s), the investment is completed, and the shares are issued or acquired by the investor, alongside the wiring or injection of the investment funds simultaneously, in accordance with the Companies Act and the rules thereunder.

Conditions Subsequent



- Target and the promoters, or the selling shareholders, are obliged to complete all post-closing actions required to complete the issuance or acquisition of shares (typically, the reporting requirements), and any other conditions subsequent required by the investor and agreed upon in the investment agreement, including the actions and conditions arising from the due diligence conducted by the investor

Stakeholders in the Transaction

DIRECTORS

EMPLOYEES OF THE TARGET (GENERALLY KEY EMPLOYEES OR MANAGERIAL PERSONS)

CREDITORS AND DEBTORS OF THE TARGET

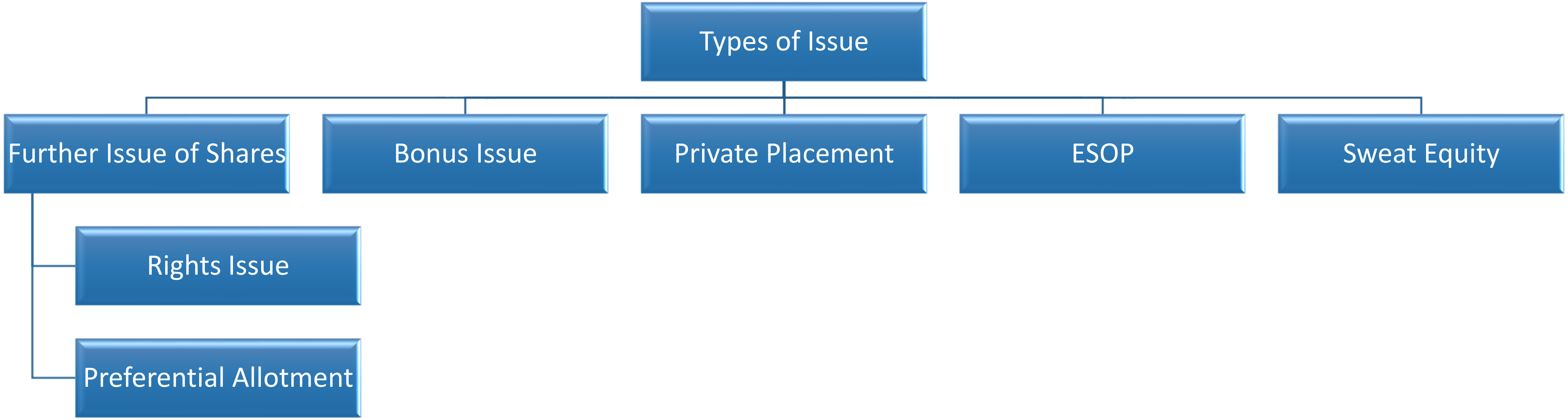
CUSTOMERS OF THE TARGET

LEGAL AND FINANCIAL ADVISERS

Structuring Considerations

Primary Investment

- By subscribing to fresh shares (on rights basis/ pro-rata basis/ private placement) issued by the target company



What's the difference?

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PRIVATE PLACEMENT

PREFERENTIAL ISSUE

Why Private Placement / Preferential Issue?

- Most PE transactions follow the private placement route for primary issuances, as there are both regulatory and taxation related complications in adopting the rights basis in cases involving foreign investors or entities that are not already shareholders or members in the target company.

Secondary Investment

By purchasing existing shares of target company from its existing shareholders

It is imperative that selling shareholders disclose any encumbrances or charges on the shares purchase by investor.

Parties must endure signing of share transfer form and follow necessary procedures to complete transfer in dematerialized form.

Escrow mechanism can be adopted by the Parties

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Combination Investment

⑩ Combination Investment Transaction

- It is combination of both primary and secondary investment

Primary Investment

- ensures shares are no encumbered
  - Easy to realize value of investment

Secondary Investment

- risk of losing/limiting title of shares
  - difficult to follow up with selling investor

Transaction Structuring

Externalization or Off-shore Structure

- It involves the promoters of target entity to establish an overseas or foreign holding company which then holds 100% of the operating Indian entity

On-shore Structure

- It involves the promoters of target entity to establish a company in jurisdiction of its resident country. It includes primary, secondary and combination investments

Funding Structure

- Advantages and disadvantages of various funding structures are based on the type of fund or investor and the applicable registration requirements under the applicable SEBI regulations.
- Pricing guidelines under the Companies Act, FEMA and the Income Tax Act must also be considered in relation to the private equity investment based on the type of funding structure.

Investors may invest into India directly from their overseas fund in which case the type of funding structure is classified as FDI (investment into India). By adopting this offshore route of funding, Investor benefits significantly from not being required to register its investment vehicle in India.

Investors may consider setting up an AIF, to pool their investment funds onshore in India and invest therefrom not as FDI, but as a domestic rupee-based investment.

AIF depends on whether the sources of funds or its own limited partners are foreign vehicles investing in US dollars or other foreign currency or Indian domestic investors investing in Indian rupees

Structuring cross-border transactions

Governed by RBI regulations, especially FEMA

Key governing factors

- Pricing Guidelines
- Taxation laws (check if double taxation treaty has been entered with the country)

Restrictions by RBI

- RBI restricts deferred payment for the purchase of shares between a resident buyer and non-resident seller and *vice versa,*
- Not more than 25% of the total consideration for the purchase of shares can be deferred, and
- Such deferred payment must be made within 18 months of the date of execution of the transfer agreement.

Structing PE transactions with Multiple Investors

- Execution of Shareholder’s Agreement (SHA): categorizing and dividing investor groups rights
- Key governing factors:
  - Differentiate between class of shares
  - Differentiate between categories of investors and rights associated with each group
  - Check if any governmental approval is required

Key Legal Clauses

Key Negotiated Clauses

- Investment in tranches
- Reps & warranties
- Indemnity
- Liability
- Non-compete
- Non-solicit
- Founder lock-in
- Veto Matters
- Break-up fees
- Jurisdiction and dispute resolution

Investment – Risk Allocation

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Investor's Risk

- Investor enters into a deal on the basis on representation and warranties and covenants provided by the Seller. Any breach of the same can cause loss to the investor
- Investor should seek voting and decision-making rights on specific matters
- Investor should restrict the promoters from transferring their shares

Company/Promoter's Risk

- The promoters and existing shareholders rights in relation to their shares may be diluted
- The target and the promoters are obliged to provide an exit within a timeframe specified in the investment agreement
- Promoters will have to make necessary disclosures to the investor
- Promoters have to provide indemnity to the investor in case of any issues or claims that arise in relation to representations and warranties

Management Considerations

Management Incentives

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- **ESOPs (Employee Stock Options Plan)**: ESOPs are equity compensations granted to employees and executives of the target. The target sets out a vesting schedule and provides the employees with the right to buy shares in the company at the specified price within the specified timeframe.

- **SARs (Stock Appreciation Rights):** SARs are rights granted to the employees of the target as a form of bonus. This mechanism is beneficial for the target, as there is no dilution of the shareholdings of the target any and the bonus is paid subject to the target's performance.

- **Sweat Equity Shares:** These are rights granted for employee's performance and efforts in the company. The company providing sweat equity specify performance parameters on the basis of which the sweat equity shares may be granted or exercised.

(Note: A company may issue sweat equity of a maximum of 15% of the paid-up equity capital or INR 50 million in a year, whichever is higher, without prior government approval. The total issued sweat equity shares in a company cannot exceed 25% of the total paid-up capital of the company at any time. Registered start-ups are exempt from this rule and may issue sweat equity shares up to 50% of the paid-up capital for a period of five years from the date of incorporation. Sweat equity shares are locked in and non-transferable for at least three years from the date of allotment, in accordance with the Companies Act and the rules established thereunder)

Rights granted to the Shareholders:

- Governance rights (a seat on the board of directors of the company being the key one)
- Transfer rights such as tag-along rights
- Anti-dilution rights
- Right of First Refusal
- Pre-emptive rights
- Affirmative Veto Rights
- Other general rights as may be agreed between the shareholders of the company, subject to the shareholding percentage of the manager shareholders

Restrictions on the Shareholders

- Lock-in for a fixed period to ensure continued employment and engagement with the company
- Obligation to offer their shares to the investor prior to offering them to any third party
- Consequences of termination of their employment
- Restriction against non-compete and non-solicitation of the business and employees of the company

Governance and Oversight

- **Governance rights**
  - Appointment of nominee director or investor observer
  - Investors may participate in the operational and strategic decision making of the company through this nominee director/investor observer appointed at the board.

- **Information/Veto rights**
  - Investors may be entitled to specific information or inspection rights in accordance with the terms of the investment agreements, to ensure that they have visibility on the company's performance
  - The grant of veto rights is not deemed to give ‘control' of the company instead, the veto rights are treated as protective provisions for the Investor.

Governance and Oversight

- **Employment and Operational activities**
  - Investors may be involved in the hiring and compensation of employees and conduct periodic reviews of compliance and company policies.

- **Non-compete and non-solicitation covenants**
  - Investors may ask portfolio companies to seek non-compete and non-solicitation covenants from who is exiting in the company to avoid set up of a competing business and/or solicit employees of the company.

- **Confidentiality**
  - This is the most important clause to ensure that none of the company's confidential information is not disclosed to anyone who is not intended to have access to such information.

Valuation

Valuation

- Price to be determined on the basis of valuation report of a registered valuer
- Price not to be less than the price determined on the basis of valuation report of a registered valuer
- Explanatory Statement to contain relevant date with reference to which the price has been arrived at
    - Relevant Date means a date atleast thirty days prior to the date on which the general meeting of the company is scheduled to be held

Valuation - Convertible Securities

- Where convertible securities are offered on a preferential basis with an option to apply for and get equity shares allotted
  - Price of the resultant shares pursuant to conversion to be determined
    - Upfront at the time when the offer of convertible securities is made or
    - at the time, which shall not be earlier than 30 days to the date when the holder of convertible security becomes entitled to apply for shares, on the basis of valuation report of the registered valuer given not earlier than sixty days of the date when the holder of convertible security becomes entitled to apply for shares:
- Decision to be taken at the time of offer of convertible securities

Valuation - Convertible Securities issued to Non-Residents

- FEMA NDI Rules will apply on pricing guidelines
- Valuation to be done by a Chartered Accountant or Merchant Banker
- Valuation to be done upfront
- Price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments

Valuation – Consideration other than cash

- For consideration other than cash, valuation of consideration to be done by a Registered Valuer (RV)
- RV to submit a valuation report to the company giving justification for the valuation

Exit

Exit Strategies

Strategic Investor vs. Financial Investor

Whether obligation for the Company and Promoters to provide exit?

Exit Period?

Exit Strategies

- **Private sales and initial public offerings (IPOs):** IPOs are a preferred choice for most Investors, as they ensure greater access to capital in international and domestic public markets and free transferability of shares, which allow investors to seek an exit within a defined timeframe. However, it is important to ensure that investors are subject to no lock-in requirements stipulated under applicable law in relation to such IPOs.
- **Strategic sale/third-party sale:** This involves sale of a significant stake in the company to a third party involved in similar businesses or interested in taking control of the operations of the company.
- **Drag-along rights:** This involves sale of all shares of the Investors to a third party by 'dragging' or obliging other existing shareholders to sell their shares to that third party. This right is usually given to and exercised by Investors if all other exit options fail or are not fulfilled by the company and the promoters.
- **Buyback/put option:** Buybacks and put options are typically used to end the private equity fund's investment in an unsuccessful or distressed company. This option is often seen as a last-ditch attempt to ensure an 'exit'

Legal & Regulatory Framework

Applicable Regulations

Companies Act, 2013 (MCA): It regulates issue and transfer of securities.

Income Tax Act, 1961: It regulates direct taxation-related aspects of private equity transactions, including applicable taxes on income generated.

Securities and Exchange Board of India (SEBI):

- SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018;
- SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011; and
- SEBI (Alternative Investment Funds) Regulations, 2012.

Applicable Regulations

Foreign Exchange Management Act, 1999 (RBI): It specify the conditions applicable to any issuances or transfers of securities of an Indian company to or by a person resident outside India, including pricing guidelines, remittances of sale proceeds and mandatory reporting requirements to assess and verify the fulfilment of applicable conditions.

Foreign Direct Investment Policy (DPIIT): It regulates the inflow of foreign investment into India and imposes general conditions as well as sector-specific limitations and conditions.

Note: The review of the legal provision is done in due diligence process which is conducted prior to conclusion of private equity transaction. This review also include all labour laws, environmental laws and rules providing for necessary registrations with various governmental authorities, subject to the industry or field in which the target carries out its business and operations.

Regulatory Authorities

Note: The powers of each of these authorities to govern PE transactions are dependent on the nature of the investment transactions, the parties involved and other factors that trigger the various regulatory requirements.

Ministry of Corporate Affairs (MCA)

Reserve Bank of India (RBI): RBI

Department for Promotion of Industry and Internal Trade (DPIIT)

Securities and Exchange Board of India (SEBI):

Competition Commission of India (CCI):.

Insurance Regulatory and Development Authority (IRDA)

Pension Fund Regulatory and Development Authority

Implications of Legal Provisions and Regulatory Approvals

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- **Companies Act, 2013 –** It prescribed conditions and approvals for issue of fresh or existing shares including:
  - internal approval by the board of directors and shareholders of the company, as set out in the articles of association of the company,
  - increasing or modifying the authorized share capital of the company;
  - filing forms and resolutions with the ROC; and
  - other such corporate or filing actions.

- **FDI Policy** – The policy distinguishes between:
  - Automatic Route - no prior investment approvals are required
  - Government Route - requires prior approval of investments subject to nature of the industry and implication of sectoral caps.

Governing Provisions

- Private Placement
  - Section 42
  - Rule 14 of Companies (Prospectus and Allotment of Securities) Rules, 2014
- Preferential Allotment
  - Section 62
  - Rule 13 of The Companies (Share Capital and Debentures) Rules, 2014

Private Placement

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- Private Placement Offer required to be approved by a special resolution for each of the offers or invitations
- Explanatory statement to contain the prescribed disclosures
- Special resolution not required for offer or invitation for NCD, where the proposed amount is within the limits prescribed under Section 180
- Single special resolution can be passed offer or invitation for NCD, where the proposed amount exceeds the limit specified in section 180, for all the offers or invitations for such debentures during the year.

Private Placement

- Company shall not utilise monies raised through private placement unless
  - Allotment is made
  - Return of allotment is filed

- No fresh offer or invitation shall be made unless

  - Allotments with respect to any offer or invitation made earlier have been completed or
  - Offer or invitation has been withdrawn or abandoned by the company:
  - Subject to the maximum number of identified persons, a company may, at any time, make more than one issue of securities to such class of identified persons as may be prescribed.

Further Issue of Share

- Further Issue of Shares
  - Existing Shareholders – Rights Issue
  - Employees under ESOP
  - Any other Persons

Preferential Allotment

- Other than Existing Shareholders
  - Authorised by Articles
  - Authorised by Special Resolution,
  - Conditions related to Private Placement needs to be complied with
- Provisions not to be complied with for conversion of loan / debentures into shares

Consideration other than Cash

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- Share Swap
- Acquiring Company or IP
- Against Services
- Advisors / Strategic Investors
- Conversion of loan into equity? Whether other than cash?

Tips and Traps

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Maximizing Investment transactions opportunities

- Addressing Objectives of investor and target companies effectively
- Lay more emphasis on the due diligence process and disclosure requirements
- Construct a systematic process and mechanism for the target company such that it promotes growth with accurate corporate governance practices and transparency in operations
- Examine regulations in relation to anti-competition, tax exemptions and benefits and prohibit stock manipulation
- Evaluate the sector in relation to its regulations and economic repercussions

“A good document can never be a substitute for a bad partner”

Remember

In business everything is negotiable

Questions?

Best wishes for festivities

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