LEGALITY SURROUNDING PRIVATE PLACEMENTS

Arjit Sahni

Abstract

Raising investment is quintessential for a company to grow. And if the company is a start-up, then the need for investment multiplies many folds. Companies require capital to carry out their operations. Capital can be raised through equity or debt. This article focuses on equity, more specifically, how capital can be raised through private placements. Private Placements are generally preferred over initial public offerings as money can be infused in a company more quickly and less expensively. The aim of the article is to bring forth the legality surrounding private placements- The Companies Act of 1956 and 2013, Companies (Prospectus and Allotment of Securities) Rules of 2014 and Companies (Share Capital and Debentures) Rules of 2014 contain provisions for private placements. The investor and the investee company execute Shareholders Agreement where various clauses regarding the investment are inserted. The investor compels the promoters to insert clauses that eventually make it difficult for them to carry out their business, in case of any default. The exit mechanisms inserted by the investors in the Agreement can be detrimental both to the promoters and working of the company. The article discusses the above-mentionedpoints in detail. The conclusions drawn are that,there is no denying that money through investment is required for a company to grow but the negotiation process while drafting the Shareholders Agreement is the key. There are many clauses in an Agreement which is in favor of an investor and that cannot be done away with by the promoters. These clauses are tag along, liquidation preference, third party options, put options, etc. The promoters should negotiate these clauses in a way that these do not turn out be detrimental in the future. After all, a comprehensive Shareholders Agreement is a win- win situation for all.

I- Introduction

Raising investment is important for modern day enterprises. Modern day enterprises especially start-ups need capital to start and expand their operations. Capital can be raised in two ways- equity (investment) and debt. It is important to note that for an investoran enterprise would mean a company. The reason behind this is that investors are hesitant in investing in a limited liability partnership, traditional partnership firm and sole proprietorship.

There are six ways in which a company can fund itself:

1. Inter corporate loans[1]
2. Foreign loans (These loans can be taken only in case of services relating to hotel, software and hospitality)[2]
3. Loans from Indian banks
4. Preference shares
5. Promoter equity
6. Private equity

For a start-up the earliest source of funding is promoters, founders' own money, friends and family. But after this stage investment would still be required for the business to grow. This is where angel investors come into play. They are sophisticated investors who invest their own money. They have the required knowledge and experience that is needed by a start-up as a driving force. After the angel investors, the venture capitalists would like to invest in a start-up. Unlike the angel investors, venture capitalist have a 'fund' and do not invest their own money.

An investment can be categorized into two parts:

1. Financial Investments- These types of investments are made in order to get financial returns in the form of cash flow from the company in which investment is being made. Angel investors, venture capitalistsand private equity investors make financial investments into a company and are know as financial investors.
2. Strategic Investments- These types of investments are made by big companies, which are generally cash rich, into young companies. However, sometimes-young

[1] S. 186, The Companies Act, 2013

[2] *External Commercial Borrowings and Trade Credits,* RBI/2014-15/3Master Circular No.12/2014-15, (11/07/2015), available at https://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=9069, last seen on 11/08/2015

companies end up buying the big companies. Porsche trying to buy Volkswagen is the perfect example of this.[3] These investments are often undertaken to stop the competitors from achieving higher efficiency- Facebook bought Instagram in order to stop Twitter from buying it.[4]

II- Stages in an Investment Transaction

Raising investment for a start-up is not an easy task. There are mainly six different stages that are to be followed:

1. Approaching potential investors-An entrepreneur should come in contact with a potential investor. In this stage, the entrepreneur would have to present his 'business plan'. Then there would be many rounds of discussions with focus on financial elements of the deal. Generally, at this stage the entrepreneur should enter into a 'Non Disclosure Agreement' with the investor in order to secure himself from the disclosure of his business plan.
2. Expression of interest by investors- If the investor is interested in the transaction, he would execute a 'term sheet' with the company. Term sheet is a non-bindingdocument that addresses important commercial and legal aspects of a transaction briefly in bullet points. After the investor has put forward a term sheet, then the investor and promoters shall negotiate over its key terms. This can take up to several rounds of negotiations. After the negotiations are completed, the investment documents are exchanged between the lawyers of both the parties who shall then discuss the wordings of the investment documents.
3. Due Diligence- Due Diligence can be defined as 'Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case.'[5]In case of merger or acquisition due diligence is of utmost importance. The new owners assume all the responsibilities that include the existing liabilities of the business. An

---

[3] Tony Davis, *Milestones: Porsche tries to buy VW*, available at http://www.drive.com.au/motor-news/milestones-porsche-tries-to-buy-vw-20140116-30y9i, last seen on 10/08/2015

[4] Damien Gayle, *Twitter 'tried to buy out Instagram just months BEFORE Facebook'*, Daily Mail, (17/04/2012), available at http://www.dailymail.co.uk/sciencetech/article-2130894/Twitter-tried-buy-Instagram-BEFORE-Facebook-Messaging-site-founder-stops-using-app-1bn-deal.html#ixzz3jXZb1aWG, last seen on 10/08/2015

[5] Perry v. Cedar Falls, 87 Iowa (1893, Supreme Court of the United States)

investor before making an investment would like to ensure himself of the company's track record by going through various records. This includes- corporate books and records, government regulations and filings, debt and loan documents, business and material agreements, acquisitions and dispositions, immovable property, litigation documentation, employment and related matters, contingent liabilities, insurance, intellectual property, environmental matters, financial assistance, industry related consents and approvals, etc. Any irregularities that are discovered after carrying out due diligence are supposed to be rectified by the investee company. This can, also, be the condition precedent that irregularities should be rectified in order to convince the investor to invest in the company.

4. Execution of investment documents- There are three types of documents that are required for making investment in a company-
    i. Share Purchase Agreement- A share purchase agreement is executed between the investor and shareholders to document the sale of shares, belonging to the existing shareholders, to the investors.
    ii. Share Subscription Agreement- A share subscription agreement is executed between the investor and the investee company to document the subscription of fresh shares to the investor. This is done to infuse money in the company.
    iii. Shareholder Agreement- A shareholders' agreement consists of rights over the shares issued to the investor, governance provisions and other provisions that protect the investment of the investor.
5. Conditions Precedent- Once the investment documents are signed the company is obliged to fulfill the conditions precedent by correcting any irregularity that may have come to the notice of the investor while conducting due diligence. Once all the conditions have been fulfilled the director of the company is required to issue a 'Condition Precedent' certificate to the investor stating that all the necessary approvals that were required for the investment have been successfully undertaken.
6. Inflow of money and related compliance- After fulfilling the conditions precedent and issuance of the certificate, the investor and the company agree upon a date within the time period specified in the investment agreement. On this date 'closing actions' take place. This means that on this date money is received from the investor, shares are issued to the investor, investors' directors are appointed to the board, etc.

IJESLS

III- Impact of Companies Act 2013 on Investment and Financing Transactions

As discussed above, huge amounts of money can be raised through initial public offer (hereinafter referred to as 'IPO') and the follow-on public offer but raising money from private identified investors, also known as private placement, is the simplest mode to raise money. As per Companies Act, 2013 (hereinafter referred to as 'Act of 2013), private placement means, any offer of securities or invitation to subscribe securities to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the conditions specified in this section.[6] Public companies- both listed and unlisted, can raise money through private placements.[7]The Listing Agreement of Stock Exchange and Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009[8] governs the listed companies. Public companies raise a lot of money from institutional investors and private equity investors. These investors, often, impose restrictions on transfer of shares including sale of shares by promoters. Private companies can only raise money through private placement[9] i.e. through issuance of equity or debenture bonds or by issuing shares to existing shareholders.

It is important to lay focus onthe Act of 2013 and private placements. The old Companies Act, 1956 (hereinafter referred to as 'Act of 1956') contained provisions regarding private placements that related to public companies only. But under the Act of 2013, the provisions have been extended to private companies as well. The process of undertaking private placement has been elaborated under the Act of 2013. The Act of 1956 contained no provisions for obtaining a special resolution from the shareholders, unless the articles of association (hereinafter referred to as 'AOA') contained any provision for the same. Moreover, there were no requirements for preparation of offer letters, conducting valuations and no requirement to purchase minimum number of shares.However, the only relaxation under this act is the number of investors per private placement has been increased from 49 to 200. The Act explicitly mentions that if securities are issued which are non-compliant with the provisions of the Act, then that private placement shall be considered as a public issue.[10]

However, under the Act of 2013 there are certain restrictions also on the issuance of securities through private placements:

---

[6] S.42, Explanation II (ii), The Companies Act, 2013
[7] S. 23(1)(b), The Companies Act, 2013
[8] S. 23(1)(c), The Companies Act, 2013
[9] S. 23(2)(b), The Companies Act, 2013
[10] S. 42, Explanation I, The Companies Act, 2013

1. Publication of offer through public advertisement, marketing or through distribution channels is not allowed.[11]
2. A 'Private Placement Offer Letter' must be prepared.[12]
3. The offer cannot be made to more than 50 people in one financial year or any higher number as may be prescribed.[13] However, any offer made to qualified institutional buyers and shares allotted to employees under a stock option scheme will not be taken into account while calculating the limit.[14]
4. It is important for the company to finish issuance of one kind of securities before offering or inviting for another kind of securities.[15]
5. It should be noted that value of the offer per person should not be less than Rs. 20,000 of face value of securities.
6. A company should get the security issuance valued from a registered valuer, a registered merchant or a Chartered Accountant who has been practicing for at least 10 years.

If a company fails to comply with the provisions related to private placement, its directors and the promoters shall be fined with an amount that equals the offer or invitation amount or Rs. 2 crores, whichever is higher.[16] Not only this, the company will be liable to return all the monies accepted from the subscribers within 30 days of the order imposing penalty.[17]

IV- Steps for undertaking Private Placements

The steps for undertaking private placements are:

1. Offer shall only be made to those persons whose names are recorded by the company prior to the invitation to subscribe.[18]
2. The offer letter must be prepared as per the requirements of Form No. PAS- 4.[19]
3. The shareholders of the company must approve the offer through a special resolution.It is required that the offer be made within 12 months from the date of passing the resolution.

---

[11] S. 42(8), The Companies Act, 2013
[12] S. 42(1), The Companies Act, 2013
[13] S. 42(2), The Companies Act, 2013
[14] ibid
[15] S. 42(3), The Companies Act, 2013
[16] S. 42(10), The Companies Act, 2013
[17] ibid
[18] S. 42(7), The Companies Act, 2013
[19] Rule 14(1)(a), Companies (Prospectus and Allotment of Securities) Rules, 2014

4. All invitations to offer must be sent along with the offer letter accompanied with an application form that shall be serially numbered and addressed specifically to the person whom the offer has been made.[20]
5. In Form No. PAS-5, the company shall maintain a complete record of private placement offers[21] and a copy of private placement offer letter (PAS- 4)[22]. Moreover, the company shall file the above mentioned with the registrar with the required fee as mentioned in Companies (Registration Offices and Fees) Rules, 2014 and if the company is a listed company then with SEBI within a period of 30 days of circulation of private placement offer letter.[23]
6. All monies that are to be paid for subscription of securities should be paid through cheque or demand draft or through other banking channels but not by cash.[24]
7. It is required that the company opens a separate account with a scheduled bank for receiving the subscription amount.[25]
8. Allotment of securities has to be made within 60 days of receipt of application money for such securities and if the company fails to allot the securities within the stipulated time of 60 days, in that case it is bound to repay the collected money within 15 days from the end of the 60th day.[26] Moreover, if the company even fails to repay the application money, in that case the company is bound to pay interest at the rate of 12% per annum, which is charged from the end of the 60th day.[27] However, in the case of foreign investors, the Consolidated FDI Policy provides that the company has 180 days time limit to allot securities.[28]

   The company must issue share certificates to the allottees and make necessary updates in the minutes books and registers.
9. In Form No. PAS- 3, a return of allotment has to be filed with the registrar within 30 days of allotment, with relevant fees as provided under Companies (Registration Offices and Fees) Rules, 2014[29] and the following documents:

---

[20] Rule 14 (1)(b), Companies (Prospectus and Allotment of Securities) Rules, 2014

[21] Rule 14(3), Companies (Prospectus and Allotment of Securities) Rules, 2014

[22] Rule 14(3), Companies (Prospectus and Allotment of Securities) Rules, 2014

[23] ibid

[24] S. 42(5), The Companies Act, 2013

[25] S. 40(3), The Companies Act, 2013

[26] S. 42(6), The Companies Act, 2013

[27] ibid

[28] Ministry of Commerce and Industry, Government of India, *Consolidated FDI Policy*, available at http://dipp.nic.in/English/policies/FDI_Circular_2015.pdf, last seen on 13/08/2015

[29] Rule 14(4), Companies (Prospectus and Allotment of Securities) Rules, 2014

a. Full name, Permanent Account Number and E-mail id of such security holders[30]
b. Class of security held[31]
c. Date of becoming security holder[32]
d. Number of securities held, nominal value and amount paid up on such securities and particulars of considerations received.[33]

V- Types of Securities

After an investor has undertaken a private placement in a company, he is entitled to get certain securities in that company in lieu of his investment. Generally, companies issue equity shares or preference shares or debentures or hybrid securities. Hybrid securities have characteristics of both equity shares and debentures.

If an investor is investing in an early stage company, then an equity share is the riskiest from of investment. The company would be having no proven track record. It totally depends on the performance of the company. If the company faces losses then the equity that has been provided by the equity shareholders would be wiped out completely. But if the company performs financially well then there would be increase in the share prices of the company and eventually the equity shareholders would benefit. As per the Act of 2013, there are two types of equity shares-with voting rights or with differential voting rights.[34] However, there are certain conditions that have to be fulfilled if a company wants to issue equity shares with differential voting rights[35]-

1. The AOA of the company must authorize the issue of equity shares with differential rights.[36]
2. The issue of shares must be authorized by an ordinary resolution passed at a general meeting of the shareholders.[37]
3. The shares with differential rights shall not exceed twenty-six percent of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time.[38]

---

[30] Rule 14(4)(i), Companies (Prospectus and Allotment of Securities) Rules, 2014
[31] Rule 14(4)(ii), Companies (Prospectus and Allotment of Securities) Rules, 2014
[32] Rule 14(4)(iii), Companies (Prospectus and Allotment of Securities) Rules, 2014
[33] Rule 14(4)(iv), Companies (Prospectus and Allotment of Securities) Rules, 2014
[34] S. 43(a), The Companies Act, 2013
[35] Rule 4(1), Companies (Share Capital and Debentures) Rules, 2014,
[36] Rule 4(1) (a), Companies (Share Capital and Debentures) Rules, 2014
[37] Rule 4(1) (b), Companies (Share Capital and Debentures) Rules, 2014

4. The company must have consistent track record of distributable profits for the last three years.[39]
5. The company should not have defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares.[40]
6. The company must not have any subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend.[41]
7. The company must not have defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government.[42]
8. The company must not have been penalized by Court or Tribunal during the last three years of any offence under the Reserve Bank of India Act, 1934, the Securities and Exchange Board of India Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other special Act, under which such companies being regulated by sectoral regulators.[43]

Preference shares are more related to debt. Preference shareholders get dividend in priority to the equity shareholders, but it is distributed only if the company makes profits.[44] If the company does not make profits then by default the interest will get accumulated and the preference shareholders would get all the past interest once the company makes profit.[45] As per the Act of 2013, preference shares issued by the company are to be redeemed within a period not exceeding 20 years from the date of their issue.[46] A company engaged in the business of infrastructure projects may issue preference shares for a period exceeding 20

---

[38] Rule 4(1) (c), Companies (Share Capital and Debentures) Rules, 2014
[39] Rule 4(1) (d), Companies (Share Capital and Debentures) Rules, 2014
[40] Rule 4(1) (e), Companies (Share Capital and Debentures) Rules, 2014
[41] Rule 4(1) (f), Companies (Share Capital and Debentures) Rules, 2014
[42] Rule 4(1) (g), Companies (Share Capital and Debentures) Rules, 2014
[43] Rule 4(1) (h), Companies (Share Capital and Debentures) Rules, 2014
[44] Rule 9(2) (a), Companies (Share Capital and Debentures) Rules, 2014
[45] S. 55(2), The Companies Act, 2013
[46] S. 55(1), The Companies Act, 2013

years but not exceeding 30 years.[47] Moreover, preference shareholders have the option to redeem ten percent of the shares from the 21st year onwards.[48]

Issuance of debentures is one of the methods to raise debt finance for a company. Debentures include debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.[49] As per the Act of 2013, debenture is a security and therefore can only be issued by a company through private placement. A company can issue debentures and these debentures at the time of redemption can be converted into shares, either partially or fully.[50] However, before this could be undertaken, the shareholders through special resolution must approve it in the general meeting of the company.[51]

There are certain conditions that a company should meet if it wants to issue secured debentures:

1. The date of redemption of secured debentures should not exceed ten years from the date of issue.[52] However, if a company is engaged in setting up of infrastructure projects, it may issue secured debentures for a period exceeding ten years but not exceeding thirty years.[53]
2. Such issuance of secured debentures must be made by creating a charge in favor of the debenture trustee, on the properties and assets of the company, having a value that is sufficient for repayment of the amount of debentures and interest.[54]
3. The company must appoint a denture trustee before the issue of prospectus or offer letter for subscription of its debentures.[55] It must, within 60 days of allotment of the allotment of shares, execute a debenture trust deed to protect the interest of the debenture holders.[56]

A company-issuing debenture is required to create a 'Debenture Redemption Reserve' (hereinafter referred to as 'DRR') account out of the profits of the company that shall be utilized for the redemption of debentures.[57] However, debentures issued by All India

IJESLS

---

[47] Rule 10, Companies (Share Capital and Debentures) Rules, 2014
[48] ibid
[49] S. 2(30), The Companies Act, 2013
[50] S. 71(3), The Companies Act, 2013
[51] S. 71(3), The Companies Act, 2013
[52] Rule 18(1)(a), Companies (Share Capital and Debentures) Rules, 2014
[53] Rule 18(1)(a), Companies (Share Capital and Debentures) Rules, 2014
[54] Rule 18(1)(b), Companies (Share Capital and Debentures) Rules, 2014
[55] Rule 18(1)(c), Companies (Share Capital and Debentures) Rules, 2014
[56] ibid
[57] Rule 18(7)(a), Companies (Share Capital and Debentures) Rules, 2014

Financial Institutional regulated by Reserve Bank of India and banking companies are not required to maintain a DRR.[58] NBFCs and companies engaged in manufacture and infrastructure are not required to maintain a DRR.[59]

Hybrid securities have characteristics of both equity shares and dentures. The Act of 1956 defines 'securities'- as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 and includes hybrids.[60] Moreover, as per the Act of 1956 'hybrid' means any security that has the character of more than one type of security, including their derivatives.[61]

VI- Transfer of Shares of Private and Public Companies

As per the definition of private company under the Act of 2013, the AOA restrict the right of the company to transfer its shares.[62] There are certain conditions and if those are fulfilled only then shares of private companies can be transferred. Share transfer in a private company must be according to:

1. AOA and Shareholders Agreement: Shares are transferred as per the Share Purchase Agreement (hereinafter referred to as 'SPA'). Submission of certain forms as prescribed under the Act of 2013 (discussed in point 2.) to the company, passing of board resolution by the company and entering the name of the purchasers in the name of the registers are done on the date of closing of SPA. If the shares of the promoters are transferred, the purchaser may conduct excessive diligence, as the promoters are responsible for the day-to-day activities of the company.
2. The Company Act aspects: Shares are transferred as per a proper instrument of transfer as per Form No. SH. 4 provided that the shares are held in physical form.[63] Every instrument of transfer must have the date of execution specified and must be delivered to the company within 60 days from the date of execution.[64] As per the Act of 2013, every instrument of transfer must be duly stamped, date of execution specified, specifying the name, address and occupation of the transferor and transferee and must be delivered to the company within 60 days of the date of execution along

[58] Rule (7)(b)(i), Companies (Share Capital and Debentures) Rules, 2014
[59] Rule 18(7)(b)(ii), Companies (Share Capital and Debentures) Rules, 2014
[60] S. 2(45AA), The Companies Act, 1956
[61] S. 2(19A), The Companies Act, 1956
[62] S. 2(68), The Companies Act, 2013
[63] Rule 11(1), Companies (Share Capital and Debentures) Rules, 2014
[64] ibid

with the share certificate and if the share certificates have not been prepared then along with letter of allotment of shares.[65] In case the transferor alone makes an application with reference to partly paid shares, the transfer shall not be registered unless the company gives the notice if the application to the transferee and the transferee replies within two weeks from the date of receipt of the notice with no objection.[66]It is mandatory for every company, unless prohibited by any provision of law or by court or by any tribunal, to deliver the share certificates of shares transferred within a period of 1 month from the date of receipt by the company of the instrument of transfer.[67] If any transfer of share of a deceased person is made by his legal representative, then that representative would be treated as holder at the time of execution of the instrument of transfer.[68] In case any default is made by the company with regards to section 56 of the Act of 2013, in that case the company shall be punishable with a fine ranging between Rs. 25,000 and Rs. 5,00,000 and every officer of the company shall be fined Rs. 10,000 that may extend up to Rs. 1,00,000.[69]

As discussed above, transfer of shares take place through 'SPA', 'deed of accession' to the Shareholder Agreement and Form No. SH.4. However, stamp duty is required to be paid on these. As far as transfer of shares is concerned, stamp duty is paid as per the consideration paid. Schedule IA of the Stamp Act of various states contains the rate of stamp duty on share transfers. It is to be noted that the location of the registered office has to be taken into consideration when deciding the state whose Stamp Act would be applicable.

Now, it is important to throw light on the transfer of shares with regards to public company. As per the section 111A of the Act of 1956 and section 23(1) of the Act of 2013, the shares of a public company are movable property and freely transferable. As far as listed public companies are concerned, as per Act of 2013, the SEBI Act of 1992 and the rules formed, govern these companies.[70]

Till 2010, there existed confusion whether restrictions could be imposed with respect to the transfer of shares by a public company.The Single Bench of Bombay High Court, in February 2010, while interpreting the section 111A of the Act of 1956, has held that transfer of shares

---

[65] S. 56(1), The Companies Act, 2013
[66] S. 56(3), The Companies Act, 2013
[67] S. 56(4)(c), The Companies Act, 2013
[68] S. 56(5), The Companies Act, 2013
[69] S. 56(6), The Companies Act, 2013
[70] S. 23(1)(c), The Companies Act, 2013

cannot berestricted by a public company.[71] The court held that any agreement or provisions in the AOA restricting the right of the shareholders to transfer their share is violative of section 111A read with section 9 of the Act of 1956 and there is void. However, The Division Bench of Bombay High Court, in September 2010, in the case of Messer Holdings Limited v. ShyamMadanmohanRuia[72]to some extent overruled the decision laid down in the above case. The court in this case held that:

"…an agreement by a particular shareholder or between two shareholders relating only to their own shares (by way of pledge, sale or for preemption) is a consensual arrangement entered into by them, in exercise of their right of free transferability and it consequently imposes no restriction on transferability…The concept of free transferability of shares of a public company is not affected in any manner if the shareholder expresses his willingness to sell the shares held by him to another party with right of first purchase (preemption) at the prevailing market price at the relevant time. So long as the member agrees to pay such prevailing market price and abides by other stipulations in the Act, Rules and Articles of Association there can be no violation. For the sake of free transferability both the seller and purchaser must agree to the terms of sale…. The fact that shares of public company can be subscribed and there is no prohibition for invitation to the public to subscribe to shares, unlike in the case of private company, does not whittle down the right of the shareholder of a public company to arrive at consensual agreement which is otherwise in conformity with the extant regulations and the governing laws… it is open to the shareholders to enter into consensual agreements which are not in conflict with the Articles of Association, the Act and the Rules, in relation to the specific shares held by them; and such agreement can be enforced like any other agreement. That does not impede the free transferability of shares at all…".

This clears the court's stance with respect to the transfer of shares by a public company. The effect of the decision is that an agreement that restricts the shareholders from transferring their shares is a valid agreement. However, such restrictions should be inserted in the agreement only and not in the AOA. This means that these restrictions are binding to the shareholders and not to the company.

Applying the ruling to the investor- investee, replacing the word 'shareholders' with 'promoters', an investor can levy restrictions on the sale on promoter shares. These restrictions can be in the form of:

---

[71]Western Maharashtra Development Corpn. Ltd. Vs. Bajaj Auto Limited, (2010) 154 Comp Cas 593 (Bom)

[72] Messer Holdings Limited v. ShyamMadanmohanRuia(2010) 104 SCL 293 (Bom)

IJESLS

1. Drag Along Rights
2. Right of First Refusal
3. Tag Along Rights

VII- Shareholders' Agreement

The issuance of shares can be completed if there is in place a comprehensive Shareholders' Agreement (hereinafter referred to as 'SHA'). An entrepreneur must see that such clauses are inserted in the Agreement that, in future, does not prove to be detrimental to the company. However, it cannot be denied that an investor would want to insert such clauses that give him an advantage if the company goes into liquidation. The Indian courts have not favored complete freedom in SHAs. In a landmark judgment in V.B. Rangaraj v. V.B. Gopalakrishnan[73], the Supreme Court held that:

"The only restriction on the transfer of the shares of a company is as laid down in its Articles, if any. A restriction which is not specified in the Articles is, therefore, not binding either on the company or on the shareholders. The vendee of the shares cannot be denied the registration of the shares purchased by him on a ground other than that stated in the Articles."

This means that various clauses that are inserted in SHAs including the exit mechanism clauses would not be binding on the company or the shareholders basically the promoters. However, practically, an investor would want to insert such clauses in order to secure himself if the company, in the future, does not perform well.

The clauses that are found in an SHA:

1. An investor would like to have 'Liquidity Preference' clause inserted in SHA. This term means that an investor would get his investment back upon the liquidation of the company. Not only this, they would be given preference over the other shareholders in the company. Even if the company were sold at a profit, the investors would be the first one to claim parts of profit. Therefore, 'Liquidity Preference' is not only used to minimize the investor's loss but it can also be used to maximize profits if the company is sold at a profit. This can be explained through an example. Suppose a venture capitalist values a startup at Rs. 10 crores and invests Rs. 5 crores in the startup. The total valuation of the company would be Rs. 15 crores and he would own

---

[73] V.B. Rangaraj v. V.B. Gopalakrishnan AIR 1992 SC 453

33% of the startup. Now, the company makes an exit at Rs. 30 crores. In such a case, he would get twice the money he invested i.e. Rs. 10 crores.

2. An investor would also like to have clauses in SHA that enable him to regain his stake in the company. These clauses are- ‘Veto Rights against the Issue of Fresh Shares’ and ‘Pre-emption Rights’. ‘Veto Rights against the Issue of Fresh Shares’ means that the promoters would have to take the consent of the investor before issuing fresh shares. This means that the investor would have full control over the capital structure of the company. As per the Act of 2013, ‘Pre-emption Rights’ means that the investors would have first right to subscribe to the fresh shares issued by the company.[74] This helps them to maintain their shareholding percentage.
3. An investor would like to have such clauses that ensure promoters’ commitment towards growth of the company. A ‘Promoter’s Lock-in’ clause is inserted to restrict the promoters from selling, assigning, transmitting or pledging their shares for the duration of the investment. Further, ‘Non-Compete’ clause restricts the promoters from competing with the business of the company over the investment horizon for a limited period of time after they have existed the company by either selling their shares or by terminating their employment. ‘Reverse Vesting’ clause is inserted to help the startups. If a founder plans toexit a company then his shares are taken away and are vested back as per the vesting schedule. Through this founders are restricted from leaving the company with their shares. If they were allowed to do so, in that case, the company would be left with limited equity that could be distributed to the new member.
4. An investor would want that his investment into the company is utilized in the right manner. An investor would want that such clauses are included in the SHA that give him the right to nominate his representatives in the Board of Directors of the company. These representatives do not participate in the day-to-day activities of the company but keep an eye over the daily activities of a company. An investor being a shareholder has the right to have a copy of the Memorandum of Associations, AOA, and resolutions passed by the company.[75]
5. The SHA would also contain a ‘Dispute Resolution’ clause in case any dispute arises during the functioning of the company.

[74] S. 62(1) (a), The Companies Act, 2013

[75] S. 17(1), The Companies Act, 2013

VIII- Exit Mechanisms

Exit is the ultimate aim for both strategic and financial investor. Every investor aspires for making a profitable exit. An IPO is the ideal exit mechanism but in the real market scenario it might not be always achievable. Due to ups and downs in the share market, an investor is not always able to make windfall gains when the investee company makes an IPO.

The exit mechanisms contemplated under the SHA include:

1. IPO- As discussed above, IPO is the ideal exit mechanism. An investor at the time of making investment in the company specifies the timeframe for exit in the SHA. The promoters would have the responsibility to ensure that the company is in a position to take an IPO within such timeframe. A start-up does not have a proven market record. Therefore, there is no guarantee that the company would be able to provide an exit opportunity as desired by the investor. Though the investors through SHA and AOA try to impose conditions that make it compulsory for a company to take an IPO but, eventually,that might not happen. Therefore, in this scenario there are other mechanisms available for an investor aiming at an exit from the company.
2. Third Party Sale- A 'third party sale' means that the shares of an existing investor are sold to a new investor who would be interested in the company. An apt example with regards to this transaction can be the acquisition of Alliance Tyre Group by KKR (Private Equity Firm) from Warburg Pincus (another Private Equity Firm).[76] KKR acquired 90% stake in the Alliance Tyre Group and Warburg Pincus made an exit with $522 million that is four times the investment they had made in 2007.[77]
3. Drag Along Rights- 'Drag Along Rights' provide an opportunity to the investors to force the promoters to sell their shares in the company to a third party identified by the investors. As the financial investors do not have a controlling stake in a company as opposed to strategic investors, this makes it difficult for them to exit by selling their stake. Therefore, in an SHA a 'drag along right' clause is inserted at the behest of the investor in order to compel the promoters to sell their shares.

---

[76] *KKR to Acquire Alliance Tire Group from Warburg Pincus*, Business Wire, available at http://www.businesswire.com/news/home/20130411006671/en/KKR-Acquire-Alliance-Tire-Group-Warburg-Pincus#.VdXo8HgxFPM, last seen on 15/08/2015

[77] Arun Kumar, *Investment firm KKR to acquire 90% stake in Alliance Tire*, Economic Times (12/04/2013), available at http://articles.economictimes.indiatimes.com/2013-04-12/news/38491408_1_alliance-tire-group-kkr-india-pe-firm, last seen on 15/08/2015

IJESLS

4. Put Options- A 'Put Option' clause forces the promoters to buy the shares of the investor's in case the company fails to undertake an IPO. The price of the investor's shares shall be predetermined in the SHA. However, the 'put option' extended to foreign investors violate the provisions under Foreign Exchange Management Act.
5. Buy Back of Shares- As per Private Limited Company and Unlisted Public Limited Company (Buy-Back of Securities) Rules, 1999, a company can buy back its shares by either of the following methods[78]:
    i. From the existing shareholders on a proportionate basis through private offers.
    ii. By purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

   Clause (1) of Section 77Aof the Act of 1956 and clause (1) of section 68 of the Act of 2013 lay down that a company can purchase (or buy back) its own shares and other securities out of:
    i. Its free reserves
    ii. The securities premium account
    iii. The proceeds of the issue of any shares or other specified securities

   However, proviso to both these clauses provide that AOA of the company mustnecessarily provide for buy back of shares and special resolution must be passed at the general meeting of the company authorizing the buy back of shares. However, if the buy back is less than 10% of the shares then it is not required to pass any resolution.
6. Tag Along- A 'Tag Along' clause is inserted to protect the minority shareholders when the majority shareholders, say promoters, want to exit the company by selling off their shares. SHAs explicitly contain this clause in order to discourage the promoters from selling off their shares. If a promoter wants to sell off his share in the company, in that case the investor by invoking this clause would 'tag along' with the promoter and sell off his share as well. However, it is quite possible that the promoter might be willing to sell a percentage of his shares. In that case, the investor would also sell only that percentage of his shares held in that company.

It is seen that the SHA is more inclined towards the investors. The promoters are in dire need of money for the conduct of operations of their company and therefore might agree to all the

[78] Rule 3, Private Limited Company and Unlisted Public Limited Company (Buy-Back of Securities) Rules, 1999

terms and conditions laid down by the investors. However, it is necessary that the promoters negotiate before the final draft of the SHA is prepared so that at the end it is a win-win scenario for both the promoters as well as the investors.

IX- Conclusion

Negotiation is the key for raising any investment. It is important for the promoters to negotiate thoroughly and not submit to the whims of the investor even if they are in dire need of money-

1. As far as IPO is concerned, the promoters while negotiating must opt for a 'best efforts' requirement for causing the company to undertake an IPO instead of a mandatory one.Moreover, any provision requiring a certain minimum value for undertaking an IPO should be done away with during the negotiation process.
2. As far as drag along clause, third party sale and buying back of shares are concerned; the promoters should limit the rate of return, in favor of the investor, to a reasonable level. And the promoters should not commit to personally finance any difference in the exit price, paid by a third party buyer, and the internal rate of return.
3. As far as Put Option clause is concerned, the promoters should compel the investors to specify the minimum internal rate of return at which they would like to exit.If this is left to be decided in the future, then this would put the promoters into personal financial burden.
4. As far as Tag Along clause is concerned, the promoters should negotiate and exclude Tag Along clause when the dilution is of a small pre agreed amount. The promoters should permit a full Tag Along only if the stake of the promoters in the company is less than 51%.

Raising investment is a prerequisite for a start-up or any company to grow. A company needs money for conducting its operations. In today's world, many start-ups are coming up. The promoters of such start-ups have the required intelligence but lack money needed for the operations. As discussed, money can be raised through six different ways. The focus of this article was on private placements that can be opted by both private as well as public companies. There is much legality involved if a company opts for private placements. It has been seen that the investee company submits to the whims of the investor as it is in dire need of money. As a result, the investor due to his upper hand in the negotiation process tends to add such clauses in the SHA that make it difficult for the promoters of the investee company

to carry out business as per their requirements. It is important the promoters negotiate the term sheet in a way that the clauses that are added in the final draft of the SHA are not detrimental to the company's operations.