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The Indian Private Equity Model

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Private Equity (PE) firms have long invested in Western firms using a leveraged buyout (LBO) model, whereby they acquire a company that they can grow with the ultimate goal of either selling it to a strategic buyer or taking it public. Unable to undertake the traditional LBO model in India, PE investors in Indian firms have developed a new model. Under this Indian PE Model, PE firms acquire minority interests in controlled companies using a structure that is both hybridized from other Western investment models and customized for India's complex legal environment. PE investors in India face several challenges, including continuing restrictions related to foreign investment, the corporate governance structure of Indian firms, and securities and corporate law hurdles to investments in publicly listed companies. PE investors have thus developed an Indian PE model focusing on several major issues: (i) structuring of minority investments, (ii) investor control rights, and (iii) exit strategies. Nevertheless, recent governance and regulatory difficulties, such as uncertainty regarding the legal status of put options, highlight the insufficiency of the Indian PE model to provide investors with their desired protections.

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The Indian Private Equity Model

1. Introduction

India's economic growth over the past decade has attracted unprecedented foreign direct investment (FDI). Much of this FDI has consisted of investments by private equity (PE) firms, with PE firms responsible for over USD 50 billion of total FDI in 2005–2012 (Bain & Company, 2013). PE firms, including Western PE firms, have become active investors in many sectors of India's economy. Indian company founders or promoters have generally welcomed the involvement of PE investors in providing funding and strategic advice to their companies.[1]

PE firms have long been active in Western markets. In the United States and other Western economies, PE firms traditionally seek to acquire companies that they can grow and improve with the ultimate goal of either selling the company to a strategic buyer or taking the company public via an initial public offering (IPO) (Afsharipour, 2010b). In implementing this model, PE buyers tend to acquire companies through the use of leverage. In a typical PE-sponsored leveraged buyout (LBO), the company's assets are used as collateral for the debt and its income is used to service the debt.

While the traditional PE model has been successful in developed economies, PE firms quickly realised that transplanting this model to India would prove difficult due to various legal constraints. Accordingly, PE firms in India have developed an alternate model that is both hybridised from other investment models in the West, such as venture capital (VC) investments, and customised for India's complex regulatory and governance environment (Kharegat, Utamsingh and Dossani, 2009). Thus, rather than engaging in traditional LBOs, PE firms primarily engage in minority investments in promoter-controlled firms (Bain & Company, 2011).

This report explores the structure of PE investments in Indian companies to determine how PE firms address the regulatory and corporate governance challenges prevalent in India. These challenges include continuing regulatory restrictions related to foreign investment, the corporate governance structure of Indian firms, and securities and corporate law hurdles to investments in publicly listed companies. Due to these challenges, investors must focus their

[1] The concept of "promoter" has specific legal significance in the Indian context. Promoters in India are typically controlling shareholders, but can also be those instrumental in a public offering or those named in the prospectus as promoters. *See* Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2(1)(za) (Aug. 26, 2009).

strategies and shareholders' agreements on several major issues: (i) structuring of minority investments, (ii) investor control rights, and (iii) exit strategies. The strategies used by PE firms also reflect their concerns regarding regulatory uncertainty about the structure of and exit from their investment. Nevertheless, recent governance and regulatory difficulties—such as confusion regarding the status of PE firms' ability to exit their investments using put rights—highlight that the current Indian PE model may be insufficient for providing investors with their desired protections.

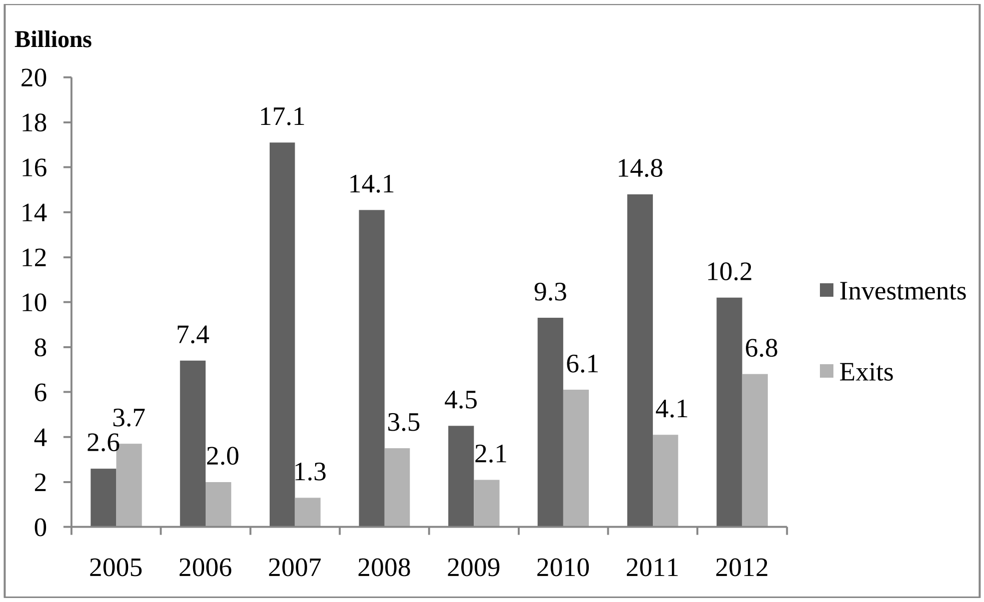
This report proceeds as follows. Section 2 provides an overview of the general state of PE investments in Indian firms. Section 3 describes the traditional LBO model and details the challenges that PE investors face in undertaking traditional LBOs in India. Section 4 analyses the Indian PE model and the challenges investors face in implementing minority investments in Indian firms. Section 5 then explores the structure of PE investments in Indian firms and chronicles the contractual methods through which PE investors have addressed some of these challenges via provisions in their shareholders' agreements. Section 5 also examines the difficulties that PE investors continue to face in addressing their concerns regarding control of and exit from their investments.

2. The Rise and Uncertain Future of Private Equity Investments in India

India's economy has undergone significant transformations since 1991 (Panagariya, 2008). India's rapid economic growth, together with its economic liberalisation, has attracted global attention. Foreign investors have rushed to direct capital into India. Indian firms and entrepreneurs have generally welcomed and advocated for the rise in inbound foreign investment, including investments from PE firms (Dharmapala and Khanna, 2007). Some of the world's most prominent PE firms have set up local offices in India. Firms such as Goldman Sachs, Warburg Pincus, Blackstone, Carlyle, KKR, and TA Associates have undertaken multi-million and even billion dollar transactions in India.

Despite the attractiveness of the potential of the Indian market, PE investments into India have fluctuated widely over the past several years. These fluctuations are due to the country's economic and political uncertainty, as well as regulatory uncertainty, such as the recent 2012 controversy regarding India's fluctuating tax policies (Bain & Company, 2013). Table 1 summarises the value of PE investments in Indian firms as well as the value of exits from such investments.

Table 1: Annual PE Investments into and Exits from Indian Firms



Source: Bain & Company (2013)

Overall, the exuberance of Western PE firms for investing in India has tempered (Kurian and Zachariah, 2012). PE firms have typically become much more stringent in choosing Indian target companies (Bain & Company, 2012). Moreover, India's recent economic struggles along with significant regulatory uncertainty have meant that PE firms must place an even greater emphasis on corporate governance and exit strategies. Given the history of the value of exits thus far, PE firms fear being unable to exit companies and also fear that target companies will seek to block any exit. Accordingly, PE firms are screening the management of target companies much more closely, attempting to build stronger ties with them on the front end, and are then structuring tougher contractual provisions in their deals.

In order to understand the strategies that PE firms use to address the aforementioned issues, it is first necessary to understand the Indian PE Model.

3. Challenges For The Traditional Private Equity Model In India's Legal Environment

Due to India's complex legal framework and restrictions, PE firms investing in Indian companies have generally been unable to use the traditional leveraged buyout (LBO) model that is commonly used in the West. Section 3.1 provides a brief overview of the traditional LBO model. Section 3.2 then examines the legal and regulatory hurdles to an LBO of an Indian company.

3.1 The Traditional Private Equity Model: A Brief Overview

In the West, PE firms are typically privately-held partnerships that acquire and "take private" publicly-traded companies so that the shares of public investors will be bought out and the company will be de-listed from the stock market. PE firms rarely use their own cash as the only currency for the acquisition consideration. More typically, PE acquisitions are structured as LBOs in which the PE firm completes the acquisition using significant debt financing from a consortium of lenders. In a PE-sponsored LBO, the seller's assets are used as collateral and the seller's cash flows are used to service the debt (Blomberg, 2008). In order to service this debt, the company's management is then required to "adhere to strict, results-oriented financial projections" and to "operate the company within tight budgetary and operational constraints" (Cheffins and Armour, 2008).

3.1.1 Corporate governance in PE acquisitions

In connection with their significant ownership stake, PE firms are often heavily involved in the governance of the acquired firm. A principal question in corporate governance is: Who controls the board of the company? In general, the PE owner directs all aspects of the board of directors of an acquired company. Not only does the PE owner select the vast majority of the company's board of directors, the general partners of the PE fund often serve as board members with significant involvement in devising and executing the company's strategic plan, with a focus on improving the company's financial performance.

In addition to board representation, the PE owner typically exercises control over many aspects of the board's decision-making process through the use of shareholder agreements. It is common for PE investors to negotiate an ability to veto key decisions, including the following: amending the articles of incorporation; changing the nature of the business; change in control transactions; issuing securities; engaging in non-arm's length transactions; replacing the CEO; incurring debt; and approving the budget. Under most PE shareholder agreements, an effective veto can be established by requiring shareholder approval for certain actions and by requiring that those actions be approved by a super-majority of the board. Shareholder agreements may also include other important provisions such as transfer restrictions (which prohibit transfers of target securities for a particular time period and transfers in excess of specified percentages), tag-along rights (i.e., the right of a shareholder to transfer securities to a person who is purchasing securities from another holder), and drag-along rights (i.e., the right of a shareholder to require other holders to transfer securities to a person who is purchasing in excess of a specified percentage of securities from such shareholder).

3.1.2 PE exit strategies

PE funds have contractually limited lifetimes—typically around 10 years. Accordingly, a PE firm must manage the acquired company with exit strategies in mind in order to realise its investment as soon as possible. In the West, PE firms generally have two exit options: (i) an IPO of the company; or (ii) a sale of the company to a strategic buyer or another financial buyer (Afsharipour, 2010b). In connection with these exit strategies, PE firms often seek specific contractual rights in the shareholder agreement such as demand and piggyback registration rights (which may include the right to force an IPO), put rights, or mandatory redemption provisions (Ibrahim, 2008).

3.2 Legal Challenges for Use of the Traditional PE Model in India

Western PE firms quickly realised that a number of legal hurdles would make traditional LBOs exceedingly difficult to undertake in India.[2] The following sections discuss some of these hurdles.

3.2.1 Legal and regulatory restrictions on LBOs

PE firms looking to undertake traditional Western-style LBOs face significant restrictions from both regulatory rules and provisions of the Indian Companies Act (Chokshi, 2007).

The Reserve Bank of India (RBI) prohibits Indian banks from granting loans for the purchase of shares in an Indian company (Rajaram and Singh, 2009). Several RBI Master Circulars mandate that domestic banks cannot grant loans to any borrowers that use the equity or debt of the company as collateral (RBI, 2012a). Moreover, the RBI strongly limits a bank's total exposure to the capital markets (RBI, 2010). Given these restrictions, a PE investor will be unable to use the shares of a target company as collateral in order to finance an LBO by raising debt in India.

In addition to the RBI restrictions, a Press Note by the Foreign Investment

[2] In addition to the legal restrictions discussed in this section, market conditions also present challenges for PE firms seeking to undertake traditional LBOs. PE firms often undertake LBOs by leverage or debt that is issued and serviced by the target company. Thus, financing an LBO requires access to a deep debt market. However, India's corporate debt market is small and marginal compared to the corporate bond markets in developed countries. For a full discussion, see Khanna and Varottil (2012).

Promotion Board (FIPB), India's highest authority regulating foreign investment in India, has placed several roadblocks to leveraging debt for the purchase of an Indian company (FIPB, 1999). The FIPB prohibits foreign investment companies from borrowing from Indian banks to purchase the securities of an Indian company. It also requires foreign PE firms to obtain permission from the FIPB for establishing a foreign-owned holding company in India. Moreover, it mandates FIPB approval if the foreign-owned holding company decides to purchase the shares of an Indian company.

The provisions of the Indian Companies Act present additional obstacles for traditional LBOs. Section 77(2) of the Companies Act prohibits listed and unlisted public limited companies from providing financial assistance to any person for the purchase of their shares. Thus, a traditional LBO where debt is raised by using the company's assets as collateral is not permitted for public companies. Since this restriction does not apply to a private company, a listed public company could conceivably delist its securities and convert itself into a private company prior to being acquired via an LBO. However, the delisting and conversion processes are not simple. In order to voluntarily delist, a company would need the approval of at least two-thirds of its members and from the stock exchanges on which it is listed. In addition, delisting would require the company to follow the complex delisting guidelines of the Indian securities regulator, the Securities and Exchange Board of India (SEBI). In order to convert to a private company, a company would also need approval from the registrar of companies, which can consider many factors, such as whether a majority of the shareholders have consented to the conversion, and whether there are any objections from the company's shareholders and creditors. Overall, the delisting and conversion processes form a huge hurdle to accomplishing an LBO.

3.2.2 Restrictions on exit through public offering

India's complex set of regulations also limit a PE firm's exit opportunities. Before a PE firm can list an Indian company on a foreign exchange, the SEBI guidelines require that it list the company on a domestic exchange (Jain and Manna, 2009). This dual listing requirement makes it difficult for PE firms that are executing an LBO to exit through a foreign listing. Further, if the company is restricted from listing on an Indian stock exchange, the PE firm will be precluded from an exit via a public offering on a foreign exchange.[3]

[3] Market factors as well as the legal limitations discussed play an important role in exiting an LBO. If the company's operations are located solely in India, an IPO in Indian markets would be most lucrative. However, if the company operates predominantly overseas or has a major export aspect to its business, an offering in foreign capital markets is likely to be more profitable.

A number of SEBI regulations add complexity to a public market exit and make it clear that PE investors engaged in an LBO of an Indian company cannot exit cleanly through an IPO. According to the SEBI's listing requirements, Indian companies must identify the promoters of the listing company for purposes of minimum contributions and the promoter lock-in. In an IPO, the promoters must own at least 20% of the post-offering stock. All other public offerings require the promoters to purchase 20% of the proposed issuance or ensure that they own 20% of the shares post-offering. Moreover, the SEBI's guidelines stipulate lock-in requirements on promoters' shares to ensure that the control and management of the company is consistent after the public offering. The minimum contribution of 20% that promoters make will be locked in for three years. If the promoters' contribution is over 20%, the additional contribution is locked in for one year. In addition, there is a one year lock-in period for the pre-offering share capital and the shares issued on a firm allotment basis.

4. The Indian Private Equity Model and Obstacles Faced by Investors

Given the challenges associated with undertaking LBOs, PE firms in India broadly undertake two types of deals: "growth" deals, where a PE fund buys a minority stake in a company, but does not get involved in the day-to-day management; and "buyouts," where a PE fund buys an ownership stake and runs the business as well. PE firms generally have the option of investing in private unlisted companies, public companies, and private companies that are subsidiaries of public companies. The structural impediments to LBOs—such as the prohibition on using leverage in such deals, a practice that is widely used elsewhere, which makes returns more attractive—bolster the predominance of minority investments. Thus, the vast majority of PE firms in India undertake "growth" deals with minority investments in public or private companies (Bain & Company, 2011).

For PE firms, such minority investments can present significant challenges given India's complex legal environment. Given the fact that many PE firms investing in Indian companies are foreign PE firms, they must ensure that their investments comply with the country's foreign investment rules. Section 4.1 provides a brief overview of India's foreign investment regime. A PE firm's status as a minority investor can cause friction with the Indian promoter. Section 4.2 discusses some of the problems that PE firms have faced when dealing with promoters. In addition to corporate governance challenges related to promoter control, the Companies Act generally imposes greater requirements, particularly corporate governance requirements, on public companies and their subsidiaries. Indian securities regulation prescribes even more rigorous norms for public listed companies. Thus, PE firms face significant obstacles when investing in listed companies in India. Section 4.3 discusses additional legal issues faced by PE firms investing in listed companies.

4.1 The Regulatory Framework for Investments by Foreign PE Firms

The general rules of Indian company law and the exchange control regulations govern the investments made in India by foreign PE firms. Foreign PE firms are not directly regulated by any specific Indian regulatory authority, but are subject to the same regulations for investment that govern other non-Venture Capital foreign investments.[4] The Indian government classifies all foreign PE investments as either foreign institutional investment (FII) for investments in listed companies or foreign direct investment (FDI) for deals with unlisted companies (Kohli, 2009).

PE firms have invested in a variety of Indian companies, although various exchange control norms may limit the potential targets for foreign PE firms. Investments by foreign PE firms are governed by India's FDI rules. FDI generally does not require regulatory approval and falls under the "automatic route" of the RBI (RBI, 2012b). Nevertheless, unless the company operates in a sector in which 100% FDI is allowed, various sectoral caps may apply, and the PE fund may not be able to acquire 100% of the shares of such a company without approval from the FIPB, which may not always be forthcoming. Moreover, FDI is prohibited in certain sectors, such as agriculture.

4.2 Promoter Control of Indian Firms

The vast majority of PE investments in India are minority stakes in companies. In addition to the restrictions on LBOs discussed in Section 3, the traditional family-controlled ownership structure of Indian firms has resulted in the small ownership stake of PE investors. Such minority investments are not without risks and frictions with promoters.

Cultural conditions play an important role in the predominance of minority investments by PE firms. Traditionally, India's business owners pass on businesses to family members (Afsharipour, 2009). Management, which often includes company founders, is usually unwilling to cede control of their

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[4] The SEBI has issued and periodically amends venture capital norms for foreign VCs in the form of the SEBI (Foreign Venture Capital Investor) Regulations, 2000. These regulations have evolved over time to create a favourable regulatory environment for VCs. For example, foreign VCs are exempt from compliance with certain key foreign investment rules, including the rules governing the price at which the shares of Indian companies may be bought or sold by them.

businesses to PE investors.

The predominance of promoter-controlled family-owned companies in India combined with the perception that some companies lack professional management, transparency, and modern management systems have led to governance concerns among PE investors (Hosangady, 2009). Since investments usually involve a minority stake, PE firms have limited influence over the company's direction and may experience roadblocks in their attempts to drive fast growth. Family dynamics and relationships may add to the problem, and contribute to issues about the adaptability of the firm (Afsharipour, 2010a). Moreover, the management information that a family-owned company provides to its foreign PE may be subpar compared to the information that PE firms receive from management in the West.

The corporate governance of Indian firms can result in friction between PE investors and promoters. PE managers face the dual task of discovering the right company at the right valuation that also understands the value of a PE partnership. Promoters often view PE firms simply as a source of capital rather than as an influx of capital plus expertise as well as knowledge of best business practices. Often, promoters expect PE firms to be passive investors on the sidelines while PE investors seek to play a pivotal role in guiding the business. Since management focuses on getting the most money for the sale of a stake in their business, valuation is the overriding consideration in choosing a PE investor to the exclusion of other considerations. Combining management's desire to obtain top-dollar with the growing pools of PE capital leads to fierce competition among PE firms. Consequently, the target company's management often holds the bargaining power and dictates the terms of investments. The desire to retain control along with bargaining power has resulted in more minority investments (Bain & Company, 2011).

The promoter-controlled nature of Indian firms raises important corporate governance concerns for PE investors. The recent Lilliput Kidswear controversy is a prime example of PE concerns (Ambavat, 2012). In 2010, Bain Capital and TPG Capital invested roughly USD 86 million for a 45% stake in the Indian clothing company. By 2011, tensions between Bain/TPG and Lilliput's founder Sandeep Narula reached a fevered pitch. Narula eventually moved to court to prevent the PE firms' interference in the day–to-day activities of Lilliput and actively sought to prevent Bain or TPG from exiting their investments (Aldred and Flaherty, 2012). By 2012, the firms valued their investment in Lilliput at zero and accused Lilliput of accounting fraud. Eventually, the two sides reached a settlement in late 2012, with TPG and Bain selling back their stakes in the company to Narula with zero returns and Narula withdrawing his case against them.

4.3 Challenges to Investing in Listed Companies

PE investments in publicly-traded or listed companies—private investments in public equity, known as PIPE transactions—can be quite complicated. PE investors need to be cautious when receiving non-public information; moreover, such transactions can be subject to the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (henceforward, "Takeover Code").

4.3.1 Due diligence issues in PIPE transactions

Prior to committing capital, PE firms conduct extensive due diligence on target companies. Indian law, however, imposes major obstacles on an investor's ability to perform this due diligence on a listed company (Stewart and Shroff, 2007). The required disclosures are limited and do not include financial projections or future business plans. As a result, PE firms often approach the target's management to request access to financial, operational, and legal data of the company.

The PE firm must be extremely cautious because due diligence investigations of listed companies are covered by the provisions of the SEBI's insider trading regulations (Varottil, 2008). During due diligence, the PE investor may obtain unpublished, price-sensitive information. The insider trading regulations restrict persons that obtain this information about a listed company from buying or selling securities of that company. A non-exhaustive list of information that is price-sensitive includes periodic financials, intended declaration of dividends, stock issuance or repurchase plans, expansion plans, a proposed merger or consolidation, or a sale of assets or business units. A PE firm receiving any of this information will be considered an "insider" covered by the regulations. These regulations make PE firms doubt their ability to perform a successful due diligence investigation without jeopardising their chance to invest in the target.

4.3.2 Takeover regulations and PIPE transactions

The Takeover Code applies to the acquisition of shares in a public listed company that would take the investor's ownership in such a company over certain specified percentages, and to the acquisition of "control" over the company, whether or not any shares are being acquired. The Takeover Code requires PE firms that acquire a substantial number of shares or voting rights of a listed company to make a mandatory offer, along with significant disclosures, to the public shareholders of that company.

The Takeover Code underwent significant amendment in late 2011, in part to provide greater flexibility to investors, including PE firms (SEBI, 2010). For example, under the pre-2011 rules, investors could not acquire 15% or more of a listed Indian company without making a mandatory offer for an additional 20% of the outstanding public shares (Open Offer). Pursuant to the advice of the Takeover Regulations Advisory Committee (TRAC), the revised code increased this 15% trigger to 25% (SEBI, 2010). In addition, acquirers holding 25% or more voting rights in the target company can acquire additional shares or voting rights up to 5% of the total voting rights in any financial year, up to the maximum permissible non-public shareholding limit (generally 75%). However, a mandatory open offer is triggered by creeping acquisition of more than 5% voting rights in a financial year by an acquirer who already holds 25% or more voting rights in the target company. These changes were designed in part to enable the PE industry to enter into transactions of a more reasonable size (Sundaresan, 2010). Analysts also expect that the volume of PIPE deals will rise, and that companies with investors holding just below 15% equity will see increased activity (Mehra, 2010).

Other accompanying changes may also alter the predominance of minority investments by PE funds. For example, a key change in the Takeover Code is to increase the size of the mandatory offer from 20% to 26% of the public shares (SEBI, 2011). Thus, acquirers proposing to acquire 25% or more of the target company will have to make an open offer to acquire an additional 26% of the public's shares. These changes may enable PE funds that are willing to comply with due diligence and disclosure requirements to obtain a majority stake or to take over an Indian company that has a founder/promoter who holds less than 50% of the company's outstanding shares (Maitra, 2010). Of course, PE investors will need a greater amount of capital to complete an offer. Some analysts predict that the increase in the size of the mandatory offer will benefit foreign PE investors who can raise capital overseas at a lower cost (Shah and Sheth, 2010).

One significant impact of the Takeover Code for PIPE transactions is the definition of "control" under the code. When a PE firm acquires rights in listed companies (e.g., veto rights on key decisions), the PE firm may have obtained "control" over the company, triggering the mandatory offer requirements. This is largely due to the SEBI's adoption of an expansive interpretation of the term "control." The Takeover Code defines "control" in a broad, inclusive manner, as including: "the right to appoint the majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner." Thus far, it remains up in the air whether a PE fund with certain veto powers or influence on strategic decisions has "control" and must, therefore, conduct a mandatory offer (Shah and Sheth, 2010).

The new Takeover Code no longer allows PE investors to pay promoters up to a control premium as a non-compete fee. Thus, all shareholders must be offered the same price per share by the PE investor. Analysts have argued that this change overlooks the fact that promoters are knowledgeable of the day-to-day operations and management of the company, and that if promoters depart the company without a non-compete agreement, a major threat to the interests of the PE acquirer and the company exists.

The Takeover Code also imposes disclosure obligations on PE investors. Generally, within two days of acquiring certain thresholds of ownership, the PE firm must disclose its shareholdings to the company and the stock exchange where it is listed. Further, any shareholder that has "control" or owns over 15% of the company must disclose its shareholdings annually. There are more onerous disclosure requirements for covered shareholders and insiders.

5. The Indian Private Equity Model: Structure, Control and Exit

Given some of the challenges discussed in Section 4, PE investors have used innovative structures to protect their interests. As minority investors in companies with significant majority shareholder control, PE firms are often concerned about how to address the corporate governance issues and majority-minority shareholder agency costs that arise in Indian firms.[5] These concerns are increasingly being reflected in the terms of the shareholders' agreements between PE investors and the investee company. Section 5.1 summarises the types of structures used by PE investors, as well as their potential benefits and shortcomings. Section 5.2 then analyses some of the innovations used by PE firms in shareholders' agreements to address their corporate governance concerns.

[5] While for publicly owned firms with diverse ownership, the governance concern is primarily about the agency costs of management vis-à-vis shareholders, for firms with controlling shareholders, the "fundamental concern that needs to be addressed by governance arrangements is the controlling shareholder's opportunism." For an overview of the differences between controlled and non-controlled companies, see Bebchuk and Hamdani (2009). In controlled family-owned entities, various family members often serve in the executive management or on board positions. Thus, the minority shareholders of controlled entities are often concerned about self-dealing transactions and other types of expropriation or extraction of wealth (tunnelling) by majority stockholders. *See*, e.g., Johnson, La Porta, Lopez-de-Silanes and Shleifer (2000). The authors define tunnelling as the "transfer of resources out of a company to its controlling shareholder (who is typically also a top manager)."

5.1 The Structure of Private Equity Investments into Indian Firms

A variety of structures are employed in PE investments and acquisitions (Nishith Desai Associates, 2010). According to PE consultant Bain & Co., while straight equity purchases will remain the norm, the use of convertible instruments has increased significantly over the past several years (Bain Private Equity Report, 2010). There are several reasons why foreign investors negotiate part (occasionally the whole) of their investment in the form of some other instrument. These reasons include: (i) dividend and/or liquidation preferences; (ii) sector caps arising from Indian exchange control laws; (iii) the desire for disproportionate voting rights on its investment in return for the strategic value that the foreign investor will add; and (iv) potential liquidity in overseas markets and more flexibility in terms of exit options (Parikh, 2009).

5.1.1 Equity securities

Some PE investors obtain equity, i.e., common stock, in exchange for their investment in the company. Equity shares are the same ordinary equity shares held by the company's promoters. When PE firms invest in equity shares, their shares have the same rights as the existing shares of the company and have no special rights on the assets or the earnings of the company. Thus, if the company goes bankrupt, common shareholders are paid after debt holders, preferred shareholders, and other creditors of the company.

5.1.2 Convertible preference shares

In addition to (and at times in place of) the use of equity common stock, PE investment into Indian companies can be structured through the issue of compulsorily convertible preference shares (i.e., preferred stock) or fully convertible debentures that are convertible into equity based on a specified conversion ratio upon maturity. Such preferential instruments get paid ahead of equity instruments if the company winds up, and they also enjoy the right to receive preferential dividend.[6]

Under Indian company law, convertible preference shares have no voting rights, with limited exceptions. The limitations on voting rights give preference shareholders little to no control over the company. PE investors generally overcome such voting obstacles through the use of shareholders' agreements (to which the company is also usually a party) that confer rights and impose obligations beyond those provided by company law (Varottil, 2010). Section

[6] Under Indian company law, a preference share by definition gets a preference over the other shareholders as to dividends and recovery of capital in the event of liquidation. *See* Section 85 of The Companies Act, No. 1 of 1956.

5.2 provides an overview of the control provisions typically included in such agreements.

There are also differences between private and public companies. In the private company context, preference shares can be given the same rights, or more rights, as equity shares via the company's articles of association.[7] Though this liberty exists, if the private company goes public, any preference shares with rights additional to those of equity shareholders must be redeemed or restructured to comply with the Companies Act. If the investor is seeking an exit via an IPO or is investing in a listed company, the usual structure will be mostly equity and some preference shares.

Mandatorily convertible preference shares are treated on a par with equity for purposes of FDI sector caps. Furthermore, only mandatorily convertible preference shares can be issued to foreign PE investors under the FDI scheme (RBI, 2012b). Adding to this hurdle, the RBI has prescribed that the dividend payable on all convertible preference shares issued to non-resident parties cannot be in excess of 300 basis points over the prime lending rate of the State Bank of India on an annual basis (Stewart and Shroff, 2007).

Normally, an investment structure using preference/preferred capital provides the investor with downside protection while retaining full upside potential. In India, however, the convertible preference shares of a listed company must be converted into equity shares within 18 months of issuance or they become non-convertible preference shares. This means that PE investors have 18 months to capture the upside potential (but forego downside protection) or maintain downside protection by remaining a preference shareholder (foregoing upside potential).

One of the advantages of the preference share to a PE firm is avoiding the mandatory offer requirements of the Takeover Code (Nair, 2010). This means that the PE firm can cash out part of its existing stake prior to acquiring more equity and exceeding the 5% threshold limit.

5.1.3 Convertible debt

Under convertible debt instruments, the debt holder receives interest from the

[7] The Articles of Association constitute an agreement between the company and its members as well as the members *inter se*, and is binding on all the members. Section 36(1) of the Companies Act states that the registered Memorandum and Articles of Association of a company binds the company and the members to the same extent as if they respectively had been signed by the company and each member, and 'member' as defined in Section 41 includes any person who has subscribed to the Memorandum of a company and any person holding equity shares of the company whose name has been entered in the register of members or in depository's records.

company until the maturity date, after which the debt converts into equity shares. Mandatorily convertible debt is treated the same as equity for determining an FDI sector cap. On the other hand, optionally convertible or non-convertible debentures will be construed as debt, and foreign investors will need prior approval from the FIPB and the RBI to invest via these instruments (RBI, 2007a). Moreover, investment in optionally convertible or non-convertible debentures will require compliance with the restrictive guidelines for external commercial borrowings (RBI, 2007b). Thus, a foreign PE investor must always invest in fully and compulsorily convertible instruments.

5.1.4 Warrants

Warrants are instruments that can be converted into equity shares at the convenience of the holder by paying a conversion price. Outstanding warrants are not taken into consideration for evaluating FDI sector caps. This is the primary reason why foreign PE firms use warrants, i.e., as stopgap instruments to ensure that the investment does not exceed the sector caps. At the same time, warrants retain the right to acquire the underlying equity shares within a specified timeframe in the hope that the regulatory regime might change.

Warrants have their own limitations. Most obviously, a warrant is only a right to subscribe to shares at a later date, meaning that investors do not get any of the rights attached to shares (e.g., dividends, voting rights). A warrant makes sense only when used as a stopgap arrangement, with the investor obtaining compensation via other contractual arrangements with the company. If the company that the PE firm invests in chooses to have an IPO prior to any changes in the FDI sector caps, the investor would effectively have to forfeit the shares underlying the warrants. This is due to the SEBI's requirement that all convertible securities outstanding in a company should be converted into equity shares prior to an IPO. Therefore, warrants can be extremely risky.

5.2 Control and Exit Rights in the Indian Private Equity Model

In order to address their governance concerns as minority investors, PE firms typically insist on shareholders' agreements with specific contractual provisions that set forth matters on which the board and the shareholders of the company cannot take action if the PE investor exercises its veto rights. If the PE investor has invested through the use of compulsorily convertible preference shares or fully convertible debentures, the shareholders' agreement will include provisions to provide the PE investor with voting rights from day one at general meetings on an as-converted-to-common stock basis.

Given that governance and regulatory problems may jeopardise the investment, PE investors often include extensive provisions relating to exit rights. PE investors usually make minority investments in the form of equity investments with put/call rights to existing shareholders (usually the management) and buybacks by the company over time. Nevertheless, there is currently significant regulatory uncertainty over the legal status of the “put” and “call” options favoured by PE investors.

Many of the provisions of the shareholders’ agreements found in Indian PE deals mirror those found in VC deals in the United States, where control and exit rights are central issues in the deal. Both types of deals use similar forms of instruments. PE and VC transactions involve negotiations over board representation and staged financing, the use of protective provisions to maintain control over their investments, and the possible use of exiting through specific rights of exit (Fried and Ganor, 2006).

6.1.1 Control rights in shareholders’ agreements

In India, shareholders’ agreements typically give minority shareholders rights such as:

- a board seat and veto rights over certain transactions;
- pre-emption rights to participate in future financing rounds by the company;
- restriction on sales (e.g., right of first refusal) and co-sale rights;
- anti-dilution price protections;
- drag-along rights (although courts in India are opposed to forced sales and these rights, though contractually agreed to, may ultimately not be enforced);
- arbitration clause (especially as litigation is a weak enforcement mechanism in India) with neutral country arbitration (Riedy, 2008).

The following sections address a few of these provisions.

Board representation

Shareholders’ agreements typically include provisions on the maximum number of directors on the board, the number of nominee directors from each party, who will be the chairperson of the board meeting, the quorum required for a board meeting, whether the chairperson will have a casting vote, and other such matters pertaining to the board. A PE investor in India almost always requires the right to appoint at least one nominee director on the board of the company. The shareholders’ agreement will also provide that the quorum cannot be constituted unless such nominee director is present at board meetings, and the investor as a shareholder is present at shareholder meetings.

Protective provisions

In the West, VCs usually receive specific veto rights over major decisions (Bartlett, 2006). These "protective provisions" are important to help VCs protect themselves from forced exit, whether through business combinations or forced IPOs, through the use of protective provisions (Smith, 2005). Protective provisions are complementary when the VC has board control and are more important when it does not (Ibrahim, 2008). Protective provisions only create a right to block unfavourable transactions, i.e., they protect against opportunistic entrepreneurial behaviour but are not an affirmative grant of power (Broughman, 2010).

The most common protective provisions include VC consent for business combinations and acquisitions, amendment of the corporation's charter, redemption of common stock, payment of common stock dividends, issuance of more preferred stock, a significant change in business conducted, and incurrence of debt. VCs also typically negotiate for a catch-all provision in addition to the list of provisions that explicitly require their consent. The catch-all provision allows VCs to veto any action that materially modifies their rights under the company.

Similar to Western VC investors, PE investors in Indian firms rely on protective provisions in their shareholders' agreements. For example, a shareholders' agreement can specify matters that will require the consent of both promoters and PE investors in general meetings, such as changes in the capital structure of the company, fresh issue of capital, amendment of the memorandum and articles of the company, and a change in the auditors. Investors also require that the shareholders' agreement include provisions that provide the investor information rights, including the right to inspect records and premises, and to conduct an independent audit.

Recently, PE firms have introduced new deal technologies in shareholders' agreements to further address corporate governance issues. PE firms, wary of Lilliput-like fiascos and eyeing favourable investment opportunities in other markets, have insisted on more stringent protective provisions. In particular, firms are looking for anti-bribery clauses, insurance against unauthorised use of funds, and mandatory arbitration in Singapore. PE firms typically have a representative on the company's board, and recently have sought protections such as indemnity for their own board members against allegations of wrongdoing or control of important committees, such as the audit or compensation committees (Chaudhary and Subramani, 2012). Given the challenges faced by PE firms in deals such as Lilliput, analysts expect that PE investors will introduce even greater corporate governance in target companies (Naidu and Sowkar, 2012).

6.1.2 Exit options for PE investors

For PE investors, a smooth exit from the investment is imperative in determining the investment's overall success. Exit can be achieved via various means such a sale of securities by the PE investor into the stock markets in the case of listed securities, an IPO by the Indian company, a strategic sale to another operating company, or a private sale to another investor (in the case of both listed and unlisted securities). Some of the most common exit mechanisms used by PE investors in India to address exit are similar to those found in VC investment agreements in the West. For example, VC agreements typically involve contractual rights of exit such as redemption rights, which require the company to repurchase shares as specified in the contract.

In India, PE investors negotiate for several alternative exit mechanisms in their shareholders' agreements. These mechanisms include a buyback by the company of the PE firm's stake or a put option against the company's promoters. In general, a company buyback of shares is less attractive than a put option due to restrictions under the Indian company law. For example, the Companies Act limits the maximum amount that a company can pay to repurchase shares, as well as the maximum percentage of shares that may be repurchased annually. Moreover, the company is prohibited (for a period of six months from the buyback) from issuing any further securities of the type that was bought back. Thus, in general, PE investors prefer to negotiate for the right to put their shares to the company's promoters. However, the enforceability of such put options is currently under significant debate due to the "stringent securities legislation that has been supported by strict judicial interpretation" (Varottil, 2011) and the SEBI's express ban on options in Indian companies' securities (see discussion under Section 5.2.3).

6.1.3 Enforceability of shareholders' agreements

One of the most significant legal challenges for PE investments in Indian firms is the lack of clarity regarding the enforceability of the rights and obligations set forth in shareholders' agreements. Shareholders' agreements in the context of PE investments have gained popularity only in the last few years in India. Indian courts have not had many opportunities to address the validity and enforceability of the various types of rights and clauses contained in such agreements. Given that litigation in India can take a significant amount of time (Armour and Lele, 2009), the parties involved usually provide for arbitration as the dispute settlement mechanism in the shareholders' agreement (Raja and Badami, 2012).

General issues regarding the enforceability of shareholders' agreements

In its one landmark decision on shareholders' agreements, the Supreme Court of India made explicit that the terms and conditions of a shareholders' agreement are not binding on the Indian company unless they are incorporated into the articles of association (Gandhi, 2008).[8] Accordingly, PE firms must push to have the agreement terms written into the articles of association. Despite this decision, lower Indian courts still disagree over whether there is complete freedom of contract when the provisions of shareholders' agreements appeared to be inconsistent with the tenor of company legislation (Varottil, 2010).[9] However, in a recent (2010) case, the Bombay High Court recognised rights *inter se* among shareholders in a case where the validity of a right of first refusal in a shareholders' agreement was called to question.[10] While the Bombay High Court's decision provides some relief to PE investors regarding the enforceability of their rights under shareholders' agreements, it does not have the same force of precedent as a decision of the Indian Supreme Court.

Some provisions typically included in PE shareholders' agreements have proved particularly challenging under Indian law. For example, non-compete agreements with founders and management beyond the term specified in the contract are void and unenforceable. This may result in PE firms retaining the management rather than the typical U.S. practice of replacing the management (Kothari, 2010). Moreover, the Bombay High Court has declared unenforceable provisions of a shareholders' agreement curtailing the rights of directors if they are not included in the company's articles. The court also held that the shareholders can dictate terms to the directors only by the amendment of the articles of association.

Enforceability of exit provisions in shareholders' agreements

One of the most problematic issues to have arisen recently is the regulatory uncertainty over the legal status of put options favoured by PE investors as exit strategies.

First, in the case of foreign PE investors, exit options such as put options are subject to Indian pricing guidelines for the transfer of shares from non-resident entities to resident Indian entities or vice versa. Under Indian exchange control laws, the price at which securities may be transferred from a resident to a non-resident entity should be at or above the "fair value" calculated in accordance

[8] *See* V. B. Rangaraj v. V. B. Gopalakrishnan, A.I.R. 1992 S.C. 453 (India 1992); *see also* Gandhi (2008).

[9] *See* Varottil (2010). *See*, e.g., V.B. Rangaraj v. V.B. Gopalakrishnan (AIR 1992 SC 453); Shanti Prasad Jain v. Kalinga Tubes Ltd., (35 Com. Cas. 351 SC); Mafatlal Industries Ltd., v. Gujarat Gas Co. Ltd (97 Comp Cas 301 Guj), Pushpa Katoch v. Manu Maharani Hotels Limited ([2006] 131 Comp Cas 42 (Delhi)].

[10] *See* Messer Holdings Limited v. Shyam Madanmohan Ruia, 159 Comp. Cas. 29 (Bombay High Court, 2010).

with the prescribed rules. The fair value issue does not present significant hurdles for foreign PE firms if the company is doing well; however, if the company is doing poorly, the application of the pricing guidelines results in a lower than expected return for the PE firm.

Second, and even more importantly, put options are governed by the applicable securities regulation, including the Securities Contracts (Regulation) Act, 1956 and various notifications issued thereunder.[11] Recent announcements by the SEBI have triggered significant debate in the Indian legal community about the enforceability of put options in the securities of Indian companies. For example, in 2010, the SEBI outlawed all forward contracts,[12] and in 2011, in two cases involving the shares of listed companies, the SEBI unequivocally ruled that put and call options are invalid and unenforceable, and will not be given effect by the regulator.[13] The SEBI's interpretations regarding put options have come under attack by Indian corporate law experts who argue that the current regime is fragmented and unnecessarily restricts the investors' ability to enter into protective contracts.

6. Conclusion

Unable to undertake the traditional LBO-based PE model in India, PE investors in Indian firms have developed their own Indian PE Model. The Indian PE model is designed to address the regulatory and corporate governance challenges prevalent in India. Investors have relied on a hybridised and customised model to address the restrictions related to investment structure, investor control rights, and exit strategies. Some of these strategies—such as the use of protective provisions—have proven to be successful. Nevertheless, recent governance and regulatory difficulties—such as the

[11] The RBI also recently called into question the validity of put options held by foreign investors. Foreign investors holding put options in the securities of Indian companies are also subject to the Foreign Exchange Management Act, 1999 and the RBI regulations. The RBI views the put option exercisable by a foreign investor (with its associated downside protection) as akin to an external commercial borrowing (ECB), which is subject to several limitations. Moreover, the Government of India issued a pronouncement on September 30, 2011 that all investments in equity securities with in-built options or those supported by options sold by third parties will be considered as ECBs. The Government reversed its stance by deleting the relevant clause regarding options within a month.

[12] Securities and Exchange Board of India, Order Disposing of the Application Dated April 7, 2010 Filed by MCX Stock Exchange Limited, September 23, 2010, available at www.sebi.gov.in/cmorder/MCXExchange.pdf (Last accessed on July 15, 2013), 56-67.

[13] *See* Letter of Offer to the Shareholders of Cairn India Limited, April 8, 2011, available at http://www.sebi.gov.in/takeover/cairnlof.pdf (Last accessed on July 15, 2013); and Securities and Exchange Board of India, Letter addressed to Vulcan Engineers Limited, May 23, 2011, available at http://www.sebi.gov.in/informalguide/Vulcan/sebilettervulcan.pdf (Last accessed on July 15, 2013).

uncertainty regarding the legal status of put options—highlight the insufficiency of the existing Indian PE model to address the problems that can arise with promoter-control and to increase the PE firms’ exit opportunities. While it is beyond the scope of this paper to set forth detailed proposals for how best to amend the relevant aspects of Indian law to facilitate PE investments into Indian firms, a reconsideration of the legal regime governing such transactions is ripe for debate among scholars and regulators.

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