

INVESTOR RIGHTS

There is no denial that in view of the make in India initiative, the liberalization in the foreign direct investment policy in India, proactive government schemes and the various reforms in policies in India; the Indian economy is very attractive for foreign investors. Local investment is also a major part of running a business in India and a crucial factor contributing to Indian economy.

While considering an investment in an entity in India, any investor whether an individual or entity, whether Indian or a foreign, should seek certain rights and protective restrictions which would directly or indirectly protect its investment in the entity.

More often than not, parties insist on a quick closure of the transaction, hence many terms are either not clearly agreed to or agreed but not elaborated or specifically set out in the definitive agreements, thereby resulting in ambiguity, disputes and differences between the parties. In order to ensure that a transaction is successfully executed and to avoid prolonged discussions, it is necessary that both parties evaluate the purpose of investment, time duration of the investment if any, and crystalize the mutual understanding between the parties under the definitive agreements.

Following rights and protective restrictions are typically negotiated between the parties and do usually form part of a definitive agreement between parties:

- **Pre-Emptive Rights:**

A pre-emption right gives a shareholder the right to participate in a future financing round, on proportionate basis of their shareholding in a company, so that it gives such shareholder an opportunity to maintain its percentage stake in the company. This right enables existing shareholder the right to acquire shares, in the event of a fresh issue of shares to new investor or vide transfer of shares.

A shareholder with pre-emption rights, shall, in most cases have the right to subscribe to the fresh issue of capital on proportionate basis of the number of shares already held by the existing shareholder. However, commercial discussions and negotiations at the time of investment can also entitle the investor, the right to subscribe to shares in multiples of their investment in the company and not just proportionally.

The pre-emptive rights are excluded in the event of issuance of employee stock option, and it is a common exclusion. The investor should be mindful and take a calculated decision in the event there are other exclusions set out at the time of investment.

Negotiating on a fair pre-emptive right will not only give the investor a right to subscribe to fresh and additional shares of the Company, but it will also protect the investor from any dilution of its shareholding in the company on the entrance of a new investor in the company. The same shall also prove to be in the interest of the investor as well as the company; since the company will get the additional funding and support it required for business projections and plans.

- **Right of First Refusal (RoFR):**

An investor investing in a company, should ask for a RoFR right on his investment in the company. In any future event, if a promoter of a company intends to sell a part or whole of their share capital to a new investor, the RoFR right will ensure that the promoter first offers the said shares to the existing investor at the same price and subject to the same rights available to the prospective buyer, and the existing investor shall then have the option, not an obligation, to purchase the said promoter shares by exercising its option.

A RoFR should be insisted on by an investor, since the liability of ascertaining the valuation of the shares and a prospective buyer intending to purchase the said shares, is on the promoter intending on selling their stake in the company, and not on the investor.

- **Transfer Restrictions on Promoters:**

Prior to investing in any business, any investor would consider few aspects, such as profitability of the business, major shareholders of the company, promoters, etc. When an investor is investing in a company, especially foreign investors, as per the present foreign exchange management laws are locked-in period for a period of one year, during which share transferability by the investor is restricted. During the subsistence of the lock-in period applicable to investors, and in the absence of any lock-in restrictions on the promoters of the company, there is a possibility of the management of the company changing altogether, leaving the investor with no recourse. Accordingly, to ensure the interest of the investor, by ensuring that the management of the company doesn't change, the business stays profitable and so on; the investor should propose a lock-in period/ or a complete restriction on transfer the promoter's stake in the company.

- **Drag-along Rights (DRAG) and Tag-along Rights (TAG):**

A Drag Along Right entitles a holder of the right, to drag all the other shareholders with him at the time the shareholder wishes to sell his shares to a third party. A Tag Along Right entitles a shareholder to tag along with the other shareholder(s) wishing to sell their shares. Depending upon the investment by the investor in the share capital of the company, the investor should negotiate on getting the right to either drag or tag. If the investor is a minority stake holder, demanding for a tag along right, wherein the investor will be able to exit from the company at the same price and terms as that of the other shareholder, would be advisable.

- **Indemnity:**

Surprisingly, several investors do not conduct a full-fledged due diligence on the target company, before investing in the share capital of the company. They rely on the representations and warranties in relation to the title of the shares, business of the company and so on, which the promoters of the company undertake at the time of the investment by the investor, which are usually continuing till the closing date. Investors can also request for continuing representations and warrants. In order to protect their interest, many investors demand that the validity of the representations and warranties should be linked to an indemnity clause, thereby ensuring that the promoters of the company will be obligated to indemnify the investor if any of the representation/warrant were to be invalid or untrue.

- **Anti-dilution:**

An anti-dilution clause safeguards an investor's stake in a company from being diluted or losing their value in the event of fresh issuance of share capital. Total shares outstanding may increase because of new share issuance based on a round of equity financing. Dilution can also occur when holders of stock options, such as company employees, or holders of other optional securities exercise their respective options.

- **Seat on the Board:**

While the investor has voting rights on the shares held by the company, the investor should specifically ask for a seat on the board of the company. The investor can either participate in the meetings of the board on its own and form part of the quorum, appoint a proxy or even an observer, which would keep the investor involved in the business as well as decisions pertaining to the business of the Company.

- **Access to Information:**

An investor should demand for access to information which gives an investor the right to access financial statements, minutes of the board and general meetings.

- **Exit Rights:**

Exit rights are the most important rights which are available with an investor, as it determines the manner, time-period and return (if any) on the investment made by an investor. It is a fact that promoters insist on locking-in investors for an initial term, after which, a clearly laid out exit option right should be documented in the definitive agreements at the time of making the investment.

An investor may ask for either one or various exit options, including but not limited to initial public offering, third party purchaser, strategic sale, company buy-back, promoters buy-out. The most suitable option can be exercised by the company, and to be more precautionary, in the event the company fails to provide the investor can still not provide for a proper exit to the investor, an investor should also demand a Put option right, i.e. in the event the promoters are unable to provide the investor with an exit, the investor can ultimately exercise the put option agreed at the time of executing definitive agreements. In view of this a Put Option is another right an investor should ask and heavily negotiate on at the time of finalizing it. This right provides is an option, whereby the investor (being the owner of the right) can sell, securities held by the investor at a pre-determined price within a pre-determined time span. It may be pertinent to mention here that in case of a foreign investment; in accordance with the foreign exchange management rules, the said investor cannot be assured any return on their investment. In addition to the above, an exit option should be linked to certain breaches, which might be material in nature and against the overall understanding between the investor and the company.

The above-mentioned rights are not exhaustive but inclusive in nature. Depending on the nature of the arrangement, other rights such as fall-away of rights, seat on the committees of the board, third-party restrictions, assured returns (for Indian investors) etc., may be negotiated and discussed.

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However, an investor can rely on the rights set out hereinabove to be well informed, aware and proactive prior to investing in a company. Summarizing, it is essential that the terms and conditions of investment are as specifically laid out and as clearly set out as possible, to protect and safeguard the investor's investment in a company.

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