A Critical Analysis Of Private Equity Transactions In India

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Abstract

In Western economies the pivotal task of selling the companies to strategic buyers or taking them public via IPO and with that aim acquisition and growth of inefficient companies, is the primary motto of PE investors, wherein they finance debt via company's assets being used as collateral and its income services debt[1]. But, the hybridized model of India uses both venture capital investment of West and regulatory regime of the nation. Thus they acquire minority stake in concentrated ownership environment, unlike a traditional leverage buyout. Thus, these investors strike a chord with corporate governance and minority shareholders issues, mainly those of concentrated owners opportunism and their self dealing transactions for wealth extraction. The vital bottlenecks in their functioning are discussed below.

Private Equity Investment: A Historical Background

The focus of private equity investments on profitability since ages, cannot deny their role in world economic development by gestating innovative ideas into realities. The first firms to sow seeds of such investments, in 1946, post second world war, are believed to be-American Research and Development Corporation and J.H.Whitney & Co.,[2]. Various stages of evolution have witnessed private equity investments traverse from early stage venture capital financing to small business assistance in form of leveraged buyout to finally institutional PE players making strategic investments. Evolution of PE investments in UK took place simultaneously but lacked behind due to stringent governmental regulations and ultimately kicked off in 1980s via rationalized tax slabs and the rise in exit ease by establishment of Unlisted Securities Market (USM)[3].

The PE investments, in their early venture capital stages, originated in India in mid-1980s with PE firms swinging into full action from mid-1990s[4]. Till 2001, these investments were skewed towards IT sector but post that period, biotechnology, e-commerce, infrastructure witnessed an upsurge in these investments. The economic global slowdown and asset bubble burst post 2008-09 saw a shrinking of private equity market. This trend was reversed in 2011 and there was rise especially in Private Investment in Public Equity ("PIPE")[5]. The uneven graph of these investments, after witnessing a downside in 2012 has enjoyed a resurgence in 2018, which

[1] Jeffery Blomberg, Private Equity Transactions: Understanding Some Fundamental Principles, 17 Business Law Today 51, 51-52 (2008)
[2] 'A short (sometimes profitable) History of Private Equity' by John Steele Gordon, assessed at https://online.wsj.com/article/SBI00014240597020446800457716685022278 5654.html, last assessed on 21.04.2019
[3] 'Evolution of Global Private Equity Market: Lessons, Implications and Prospects for India' by R.K.Jain and Indrani Manna, viewed at https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2109, last assessed on 21.04.2019
[4] Ibid
[5] Assessed on Private_Equity_Investments_In_Indian_Companies.pdf, available at https://www.nishithdesai.com

witnessed a majority stake acquisition in some instances by PE players, primarily with Insolvency and Bankruptcy Code, opening up large companies with stressed assets for acquisition, yet the total PE investments has lowered slightly from $29 billion in 2017 to $28.66 billion in 2018[6].This only indicates that the in the backdrop of political uncertainties and stringent regulatory regime, forecasting a definite positive trend in private equity investments might sound over-ambitious.

Stages of Business and investment classifications

The typical method of working of PE investments includes seeking out the target company or being approached by one. Next, the investment structure gets framed via MOU between the investor and the company. Post the minimum due diligence and background check satisfaction by the investor, certain contractual agreements, including the shareholders agreement get formulated and finally the private equity investor invests in the concerned company. Such investments expect return from capital appreciation in the long term, say 7-10 years. The role of private investments transcends from early stage venture capital to huge leverage buyout. Thus the broad classification of private equity is three pronged-firstly, venture capital (which gets invested mostly at seed stage and start up stage of business but may also be involved at expansion stage when the business is beyond break even and looking for further diversification or for the purpose of purchasing replacement capital) , buy out (when the firm is looking for either management buyout or leverage capital or acquisition capital), and finally the special cases of mezzanine financing (to diversify the company via hybrid debt-equity financing), distress financing or any other form of financing.[7]

Hybrid Model: Regulatory Regime

Generally the contesting control, voting rights, pressure tactics on board of directors give limited control to minority shareholders. The PE transactions get effectuated either via equity shares, compulsorily convertible preference shares or compulsorily convertible debentures. If we look at the regulations under the **Companies Act, 2013** the statutory compliances get divided into investment related and pre investment conditions. Thus, under Section 42 and Rule 14 of **Companies (Prospectus and Allotment of Securities) Rules 2014** lay down conditions for raising funds via private placement of securities. Also, grant of pre-emptive rights to existing shareholders(S. 61(1)(a)) and its further allotment on preferential basis to employees and others (S.62(1)(b) and (c)) are dealt under **Companies (Share Capital and Debentures) Rules 2014.** Further, S.42 and 62 deal with issue of debentures, while, S.55 governs transactions related to issue of preference shares. Also, AOA of the Company needs to ensure that companies do not involve in investment via more that two layers of subsidiary investments. Further, fund accountability gets ensured by **FDI policy** issued by DIPP which flows in the nation either via automatic route or government approved route and the foreign PE investment in filters Indian economy via FDI or FPI or FVCI[8]. Also, FIPB was abolished by FDI policy of 2017. The **Foreign Exchange Management Regulations, 2017,** of RBI regulate issue of equity share, preference shares, impose restrictions on such transactions and the entry routes, sectoral caps are in line with the FDI policy.

The **SEBI (AIF) Regulations,2012** provide legal framework for private equity, hedge funds, and other pool investments. Thus, the PE funds which were earlier under the SEBI (Venture Capital Funds) Regulation, 1996, have the option now to be establish shed as a trust, company or limited liability partnership or a body corporate under category II of the 2012 regulations. Further, **SEBI(FVCI) Regulations 2000**, though not mandatory, yet

[6] 'Rewind 2018: Private equity firms bet on control deals, high-value exits', by Surajeet Das Gupta, assessed at https://www.business-standard.com/article/companies/rewind-2018-private-equity-firms-bet-on-control-deals-high-value-exits-118123000659_1.html

[7] Private Equity in India, assessed on 21.04.2019

[8] Siddharth Raja & Ashwini Vittalachar, Private Equity in India: Market and Regulatory Overview, Private Equity and Venture Capital Global Guide 2015/16(2015), available at global.practicallaw.com/8-504-2425

grant certain benefits via SEBI and RBI to outside investors investing in venture capital in India, for instance the 1 year lock in period for promoters post the IPO under **ICDR Regulations,2009** is not applicable under FVCI Regulations. The FVCI Regulations allow Indians to "maintain control over issues such as investor qualifications and debt to equity ratios"[9]. Under**, SEBI Takeover Regulations 2011** , Regulation 3 raised the trigger point from 15% to 25% of voting rights and the mandatory open offer is set at least 26% of target company's total shares. The delisting(**SEBI (Delisting of Equity Shares) Regulations, 2009)** especially under regulations 3,4, or 5)) or buy out nature of investments call for these 2011 regulations. Finally, capital gains from sale of shares invite **Income Tax Act, 1961** and the associated exemptions there under including Double Taxation Avoidance Agreement, General Anti Avoidance Rules, etc. Thus the PE transactions are boundaries by a myriad of regulations. Also the exemption ambit of convertible shares was widened from the convertible debentures to include convertible preference shares as well on conversion to equity shares post the taxation law from 1 April 2017 onwards[10].

Bottlenecks in the Working of Hybrid PE Model

The upsurge in PE investments has invited global investors like Blackstone, Goldman Sachs but only for minority investments, unlike West. The exit strategy struggle, blockage by target company, uncertain political and regulatory environment, continue to haunt PE investors. Also, where 100% FDI is not allowed various sect oral caps work. PE firms in India take growth deals(minority stake) and not buyout deals (ownership stake) in private as well as public companies(both listed and unlisted).Under traditional PE shareholders' agreement, they negotiate key veto powers, change in business, budget approval, transfer restrictions, piggybacking rights ,tag along and drag along rights and can exit the firm via IPO or selling to a strategic buyer.[11]

a)**Legal prohibition on leverage buyout**- RBI via various Master Circulars, prohibit granting of loans by domestic banks to Indian companies using its assets as collateral for debt and in general bank's capital market exposure is limited.[12] Also, FIPB placed several inhibitions on foreign investments until it was done away with in 2017 and the FDI decision one falls under concerned DIPP ministry which further raises apprehension whether the ministers are well equipped to take such intricate decisions effectively. Further, under both the 1956 (S.77(2)) and 2013 (S.67(2)) Companies act, no financial assistance for purchase of their shares can be granted by the public(listed or unlisted) companies. This restriction is not applicable for private companies, hence the public companies could go for onerous delisting via 2/3rd shareholders' majority votes for delisting need to be twice the votes against it, in addition to the SEBI rules of shareholding being 90% of total share capital and reserve book building having participation from 25% public shareholders[13].

b)Challenges with respect to exit strategy- The draft offer documents for the sale of equity shares can be filed by the seller iff the shares were here for at least 1 year by him as per Regulation 26(6) of ICDR Regulations, 2009.Also, pushing exit via IPO would require signature of all directors which could be denied on grounds of fiduciary duties. Along with this the minimum contribution, by the promoter, of 20% for 3 years and above that for 1 year, are locked in as per SEBI guidelines and that of pre IPO shares of PE firm for 1 year. All these further complicate exit via IPO. Alternatively, a company can buyback its shares but the same is made less attractive an option as under Section 68 of Companies Act, 2013 wherein, in a year, only 25% of paid up capital can be

[9] Kelly Fischer & Sophie Smyth, US Private Equity Investments in Emerging Economies, 12 Journal of International Business & Law 223,235 (2013)

[10] https://gettingthedealthrough.com/area/29/jurisdiction/13/private-equity-transactions-india/, last assessed on 21.04.2019

[11] Afra Afsharipour, Corporate Governance and the Indian Private Equity Model, 27 Nat'l L. Sch. India Rev. 17 (2015)

[12] Narendra Chokshi, Challenges Faced in Executing Leveraged Buyouts in India: The Evolution of the Growth Buyout (April2,2007) (unpublished manuscriot), available at https://www.stern.nyu.edu/sites/default/files/assets/documents/uat024317.pdf

[13] SEBI, SEBI (Delisting of Equity Shares)(Amendment)Regulations, 2015, (March 24,2015), available at https://www.sebi.gov.inlcms/sebidata/attachdocs/1427261684807.pdf

bought back along with special resolution for exercising such option.[14] Even the put option for foreign PE investors are subject to Indian "fair-value" pricing guidelines, which in case of inefficient company results in lesser than expected returns. After series of judicial interpretations surrounding the legality and validity of call and put options, the validity of same was upheld with conditions curbing speculative practices in securities market[15].

c)Shareholder's agreement- The uncertainty surrounding the enforceability of shareholder's agreements and with the apex court denying the binding nature of terms of such agreements unless the same gets included under the AOA[16], creates further problems for the PE investors. Also , even though the rights under such agreements , though enforceable legally, become difficult to be implemented if the shareholders and promoters are at loggerheads, precisely when fiduciary interest is in conflict with shareholder's interest. Also, terms in these agreements e.g. vividness of non compete agreements beyond particular limit prove problematic under Indian laws.

d**)PIPE transactions: Takeover Regulations and due diligence issues:** Post 2011, there has been rise in PIPE transactions. The limited due diligence testing by PE firms does not guarantee stable future projections. The receipt of unpublished price sensitive information during due diligence examinations carries with it the risk of being connoted as "insider" who is subject to insider trading regulations of SEBI[17] ,2015 . Also, the Takeover Code, 2011, raised the trigger point to 25%[18] and an increase from 20% to 26% for mandatory open offer for public shares. The definition of "control" under the Code includes both numerical aspect of number of directors, which is easy to analyze, as well as substantive aspect of controlling management or making policy decisions and certain strategic terms of shareholders' agreement ,for e.g., veto rights, pre-emption rights, tag along and drag along rights, board representation via nominee director make it unclear that if the control of PE investors is same as that of promoters to obligate them for performing mandatory offer[19]. The PE investors also get subjected to disclosure obligations in certain instances, under the agreement[20].

e)Concentrated Ownership of Indian Companies- The minority stake in concentrated ownership environment run at constant friction risk with the promoters which culminates into lack of transparency, poor management, PE firms acting only as source rather than influx of capital and thereby playing passive role, and ultimately poor corporate governance of which glaring example is Lilliput Kidswear controversy of 2012[21]. The tension between Sandeep Narula, Company's founder and Bian/TPG, foreign PE investors (for 45% stake) due to former alleging the latter's interference in everyday's activity of the company resulted ultimately in 2012 compromise with Narula withdrawing his case and the PE investors allowed to exit company but at zero returns, in spite of the

[14] Raja & Vittalachar

[15]Umakant Varottil, SEBI Notification on pre-Emption Rights, Put and Call Options, India Corp. Law Blog (October 4,2013), https://indiacorplaw.blogspot.com/2013/10/sebi-notification-on-pre-emption-rights.html, last assessed on 21.04.2019

[16] VB Rangarajan v VB Gopalakrishnan (1992) 1 SCC 160: AIR 1992 SC 453, See also Vishal Gandhi, Certain Legal Aspects in Private Equity & Venture Capital Investments in India 2-3 (2008)

[17]Umakant Varottil, Legal Hurdles to Private Equity Investments, India Corp Law Blog (May 20, 2008), available at https://indiacorplaw.blogspot.com/2008/05/legal-hurd;es-to-private-equity.html (Discussing SEBI's Takeover Regulations), last assessed on 21.04.2019

[18] Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2010, Report of the Takeover Regulations Advisory Committee

[19] Vishal Shah & Smit Sheth, Proposed Takeover Norms Could Be a Game Changer, Reuters (December 23, 2010), available at https://blogs.reuters.com/india-expertzone/2010/12/23/new-takeover-regulations-could-be-a-game-changer/, last assessed on 22.04.2019

[20] See Nishith Desai Associates, Public M&As In India: Takeover Code Dissected (August 12,2013) available at https://www.nishithdesai.com/fileminluser/upload/pdfs/Ma%20Lab/ Takeover%20Code%20Dissected.pdf last assessed on 22..04.2019

[21]Ambayat Shruti, M&A and PE deals face slowdown as policy paralysis bites, Financial Express (April 7,2012), available at https://archive.financialexpress.com/news/m-a-and-pe-deals-face-slowdown-as-policy-paralysis-bites/933711

complain of fraud on promoters side, they had no other option but to reach at such compromise. This is prime instance of concentrated ownership-poor governance nexus.

Conclusion: The Way Forward

The Western concept of protective provisions to block unfavorable transactions, via special veto rights, for instance, corporation's charter amendment, change in business transactions, common stock redemption,etc,do not grant control powers and similar powers are vested with Indian PE investors. Also, with PE investors diversifying their ventures and to avoid Lilliput fiasco, eye further stringent protective provisions, for instance anti-bribery provisions, indemnity of third board members from certain actions, higher standards of Corporate Governance in target companies, amongst others. But the question of such control raising PE investors to the same pedestal as promoters is yet to be answered. Also the provision for nominee director often included in shareholder's agreements, ensure PE investors get adequately represented in the board but the independent directs enjoy adequate immunity for acts occurring without their knowledge or in spite their diligence[22]. The Indian hybridized model via its protective provisions in shareholders' agreements, the resent dismantling of FIPB, exemptions under various laws and regulations pave silver lining for enhanced structuring and lower minority share holder oppression but at the same time the concerns raised above that surround the question of control and concentrated ownership will continue to haunt PE investments in India. A vibrant regulatory regime, with stricter compliance mechanism ensuring more transparent corporate governance is the need of the hour. Making a binding shareholder's agreement, with greater protection and say to minority shareholders, granting key strategic rights in directors' appointed on their behalf, a more stringent transparent action by the company in cases of out of court settlements as well as increased judicial activism to set precedents which discourage the promoters from acting arbitrarily, could go a great way in providing smooth passage for boosting private equity investments in India.

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