



RAISING GROWTH CAPITAL - STRUCTURING AND LEGAL ASPECTS

SAMISTI LEGAL

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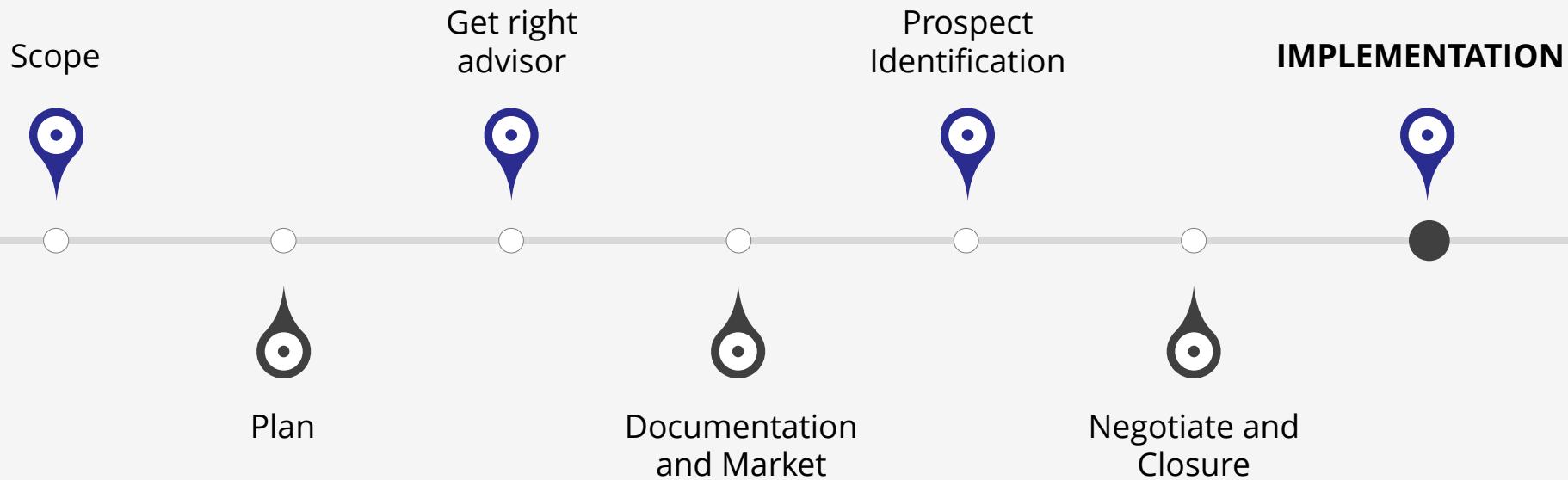
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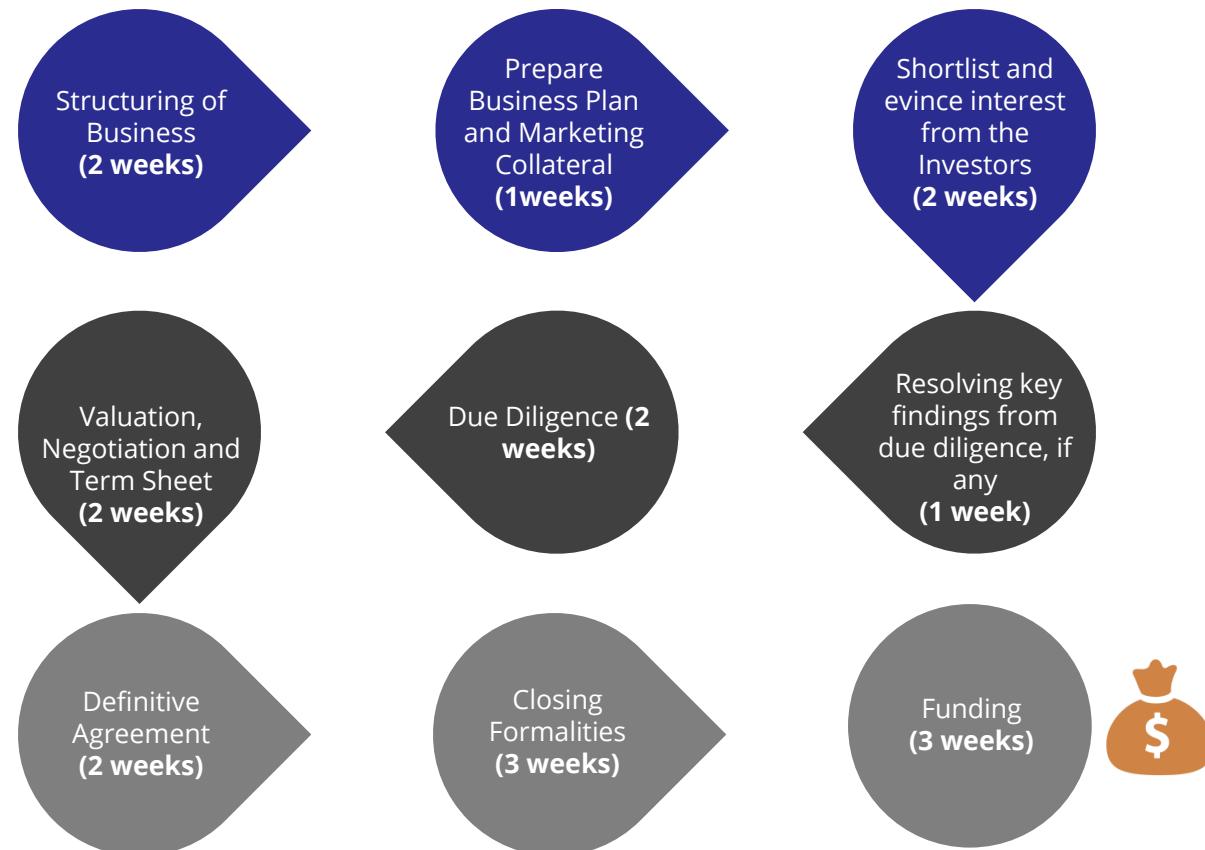
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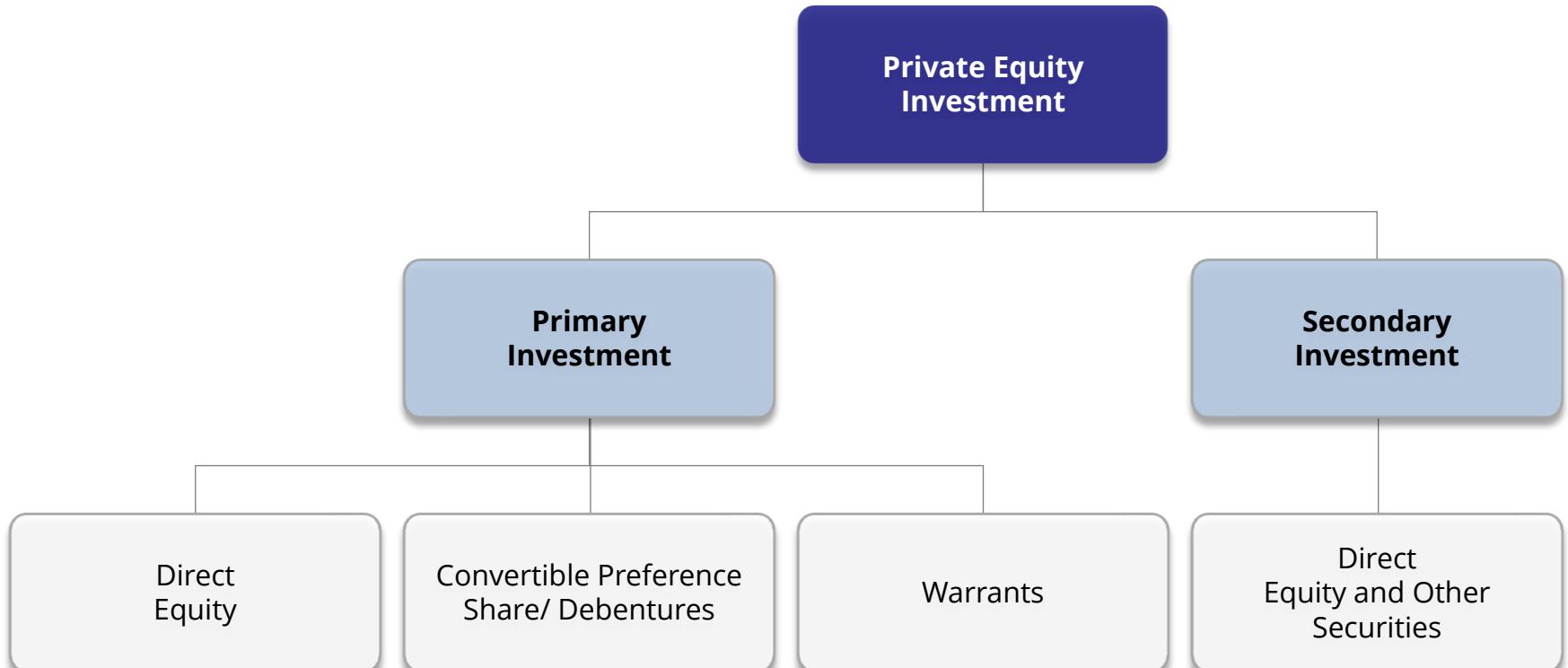
The Beginning



PE Investment Process and Estimated Time Period



Modes of PE Investment and Instruments



Valuation of Instruments

Companies Act, 2013

- Under Companies Act, price is determined based on valuation by a Registered Valuer (RV).
- Where convertible securities are issued, the resultant equity share price is determined:
 - either upfront at the time of issue of convertible securities or
 - Atleast 30 days prior to the date of entitlement to apply for shares, on the basis of valuation not earlier than 60 days of such entitlement.

Foreign Exchange Management Act, 2013

- The valuation of instruments is done as per internationally accepted pricing methodology duly certified by a Chartered Accountant or a SEBI registered Merchant Banker.

Income Tax Act, 1961

- The price shall not be more than the fair market value determined by a SEBI registered Merchant Banker.
- If shares are issued at a price in excess of the fair market value, it is taxable as per section 56(viib) under the head Income from Other Sources, with some exceptions.
- Section 56(viib) is exempted to a registered Startup i.e., if the issue price is in excess of the fair market value, the amount so raised will not be taxable.

Key Terms in a Term Sheet



Term Sheet

- Background of the Company, Investors and Proposed Transaction
- Usage of Funds and Current Share Holding Pattern
- Valuation of the Company
- New ESOP Pool, if any.
- Customary Condition Precedent
- Anticipated level of management participation by the investor
- Pre-emptive Rights
- Anti Dilution Rights
- ROFO or ROFR
- Tag Along & Drag Along Rights
- Liquidation Preference
- Agreed time period for providing exit to investors
- Upside Sharing for Promoters, if any
- Nature of term sheet – Non-Binding
- Cost Sharing
- Exclusivity Period

Note for founders:
Please involve a lawyer
at the stage of
term-sheet itself!

Key Terms in Shareholders' and Subscription Agreement

A Subscription agreement is a contract between the company and the investor laying down the terms of subscription/investment by an investor. A Shareholders' Agreement is a contract between the company and all its shareholders which sets out their rights and obligations pertaining to their shareholding/investment in a company. Critical matters that requires negotiation in Shareholders' and Subscription Agreement are as under:



Shareholder's and Share Subscription Agreement

- **Management and Quorum Rights at Board meetings as well as Shareholder's meeting**
 - ✓ Board Seat
 - ✓ Reporting by Key Employees
 - ✓ Hiring and Firing rights of KMP
 - ✓ Fall away of Rights
 - ✓ Promoters' Right to vote on critical matters in case he is not holding majority stake in the Company or terminated without cause
- **Pre-emptive Rights**
- **Anti-Dilution Rights**
 - ✓ Weighted Average vs Full Ratchet
- **Representation and warranties**
 - ✓ Disclosure Letter and Updated Disclosure Letter vis-à-vis Specific Indemnity
 - ✓ Knowledge and Materiality Qualifiers
 - ✓ Insurance for Reps and warranties
 - ✓ Time Period

Key Terms in Shareholders' and Subscription Agreement (Continued)



Shareholder's and Share Subscription Agreement

➤ Indemnity

- ✓ Time Period;
- ✓ Cap and Floor of liability
- ✓ De-minimus and basket
- ✓ Non-attachment of personal assets of Promoters except fraud, gross negligence or willful misrepresentation

➤ Transfer of shares and its restrictions

- ✓ Transfer restrictions on Promoters – Lock-In, Inter-se transfer, carve out for liquidity
- ✓ Transfer restrictions on Investors – Transfer to Competitor, ROFO/ROFR, TAG

➤ Right of first refusal versus Right of First Offer

➤ Structuring of Promote Sharing for Promoters

- ✓ Modes of sharing of Promote and tax implications

Key Terms in Shareholder's and Subscription Agreement (Continued)



Shareholder's and Share Subscription Agreement

➤ Liquidation Preference

- ✓ Determination of waterfall based on valuation at the time of Liquidity Event

➤ Events of Default and Consequences

- ✓ Breach of representations and warranties
- ✓ Non-obtainment of Investor approval for reserved matters
- ✓ Termination of Promoter for Cause
- ✓ Promoters convicted for fraud or violation of law or any material adverse change
- ✓ **Consequences:** Drag right (Full Vs. Partial), obligations of investors to fall off, promoter losing the board seat.

➤ Exit Mechanism

- ✓ Modes of exit- Strategic Sale, Third Party Sale, IPO, Promoter Lock in in case of IPO, IPO Waterfall etc.
- ✓ Failure to provide exit- Contractual breach Vs. Consequences of breach

➤ Non-compete obligation of Promoters – Period, Geography and Coverage

Key Terms of Employment Agreement for Promoters and Key Employees



Employment Agreement for Promoters and Key Employees

Employment agreement governs the relation between the entity and the key employees. Some of the key clauses which require careful consideration are as follows:

- Duties and Responsibilities
- Compensation, benefits and reimbursement policy
- Termination and its effects
- Severance Package
- Non-Compete Obligation

Private Equity/ Investors Clash with Promoters – Mitigation Plan



REASONS FOR SPATE:

- Poor Due Diligence by the Investors
- Desperate Promoters versus demanding investors
- Promoters Sweet Spot
- Promoters Pushback on governance issues
- Promoter mindset of Control
- High-value Investments

BEST PRACTICE FOR PROMOTERS TO MITIGATE RISK OF LITIGATING:

The Company which is raising funds from private equity/venture capital players will mostly witness tight obligations and limited rights, with the promoters being liable for most acts, as the Investor decides to invest relying solely on the representations given by the promoters. Many issues come up while discussing and negotiating investment terms with the Investors. The promoter should hire a good legal counsel to negotiate the agreements to avoid any future surprises.

CASE STUDY

A company "ABC Ltd" ("**Company**") has raised couple of rounds of funding and has few existing investors in the Company.

The Company intends to bring in further round of investments from a prospective investor who is 'person resident outside India'. One of the potential mode of exit to the investors is envisaged to be by way of IPO of the Company. The Promoter also wants to structure promote mechanism in the agreement.

The Company is also contesting couple of ongoing litigations including tax and others.

The Promoter also proposes to create a new ESOP Pool.

Potential Challenges:



- ✓ FDI;
- ✓ Multiple Investors - Existing and New Investors
- ✓ Ongoing Litigations which might impact valuation of the company in future;
- ✓ Promoter may not continue to hold majority stake in the Company post investment;
- ✓ Structuring of Promote

CASE STUDY



Promoter Perspective:

- ✓ FDI restrictions in the sector
- ✓ Rights of existing investors vis-à-vis rights of the incoming investor
- ✓ Promoter Rights - Affirmative matters, Reporting by Key Employees
- ✓ Specific indemnity disclosure



Investor Perspective:

- ✓ Due Diligence
- ✓ Exit bottlenecks
- ✓ Insurance for Reps and Warranties
- ✓ IPO- Categorisation, Waterfall and Lock-in

Thank You!

Q&A



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