

Private Equity Corner

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DISPUTES IN PRIVATE EQUITY: ASSESSING THE ENFORCEABILITY OF INVESTOR EXIT RIGHTS IN INDIA

- Exit Rights are essential negotiation points for incoming investors to ensure a guaranteed exit at a desirable valuation.
- Common exit mechanisms for investors include IPOs, third party sale, trade sales, etc.
- Drafting an exit clause appropriately is essential to ensure that enforceability before Indian courts, in the event of a dispute, is guaranteed.
- Enforceability concerns differ from clause to clause but may range from an unwillingness of the company/ promoters/ other shareholders to honour obligations, lack of clarity on the processes to be followed to enable the said exit, or owing to restrictions imposed by applicable law.

An exit refers to a circumstance in which an investor moves out of the company by parting with their investment in the company, usually to realize a higher value on the initial investment amount ("Exit"). Exit rights refer to clauses within transaction documents such as the Shareholders' Agreement ("SHA") which grant investors the contractual right to decide on the disposal of their securities in order to Exit the company ("Exit Rights"). Exit Rights include clauses like initial public offerings, buyback, call and put options, trade sales, and drag-along and tag-along rights. These Exit Rights are traditionally triggered on the occurrence of a defined event, which could either be expiry of a defined time period or occurrence of an event of default by the investee entity/ promoters.

Typically, Indian courts have held that Exit Rights that are private arrangements between certain shareholders of the company need not be separately added to the articles of association of a company to guarantee their enforcement. Only such Exit Rights that relay obligations on each of the shareholders and/ or company need to be added to the articles of association separately to ensure that they are enforceable in a court of law.¹

In this article, we discuss common Exit Rights available to investors in India and potential disputes that may arise in relation to the enforcement of these rights by investors, whilst providing drafting recommendations to better arm investors at the time of an Exit.

STRUCTURE OF AN EXIT CLAUSE IN TRANSACTION DOCUMENTS

Exit clauses are typically structured to require the promoters and/ or company (as negotiated) to *mandatorily* provide an Exit to the existing investors, generally within a time period that has been contractually agreed by the parties. There are two broad ways in which the investors usually prefer to draft such rights in the SHA:

Exit waterfall – In this case, a specific order is prescribed under the SHA which needs to be followed by the parties in order to give effect to the Exit. For example, the clause may first require a company to undertake an IPO, failing which undertake a buy back, failing which proceed with a third-party sale and so on. While the prescription of a waterfall within the Exit clause is generally beneficial for both parties, it tends to favour the investee company/ promoters, as it allows them to discharge their obligation in the order that has been negotiated and gives them enough opportunities to facilitate an exit before the investor triggers drag along rights under the transaction documents (as their last recourse).

Exit clauses without a waterfall – This is the converse of a waterfall clause as this does not require the company/ promoters to exert their efforts at providing an Exit in any particular order. This provides greater flexibility to the investors to decide and determine at their sole discretion which exit option they intend to trigger. For example, in case the markets do not seem ripe for a listing (which is commonly negotiated as the first Exit mode by investors), they may opt for a buyback/ third party sale.

From an enforceability standpoint, it is important to determine the exact nature of obligation on the investee company/promoters; is it to provide an Exit by any means or is it to provide an exit in the manner/sequence as contemplated in the SHA? If it is the former, the investor may not be able to initiate any proceedings against the company/promoters until all agreed and documented exit options are exhausted, whereas in the latter, if the company/promoters jump the sequence, an action may lie against them.

EXIT RIGHTS AND THEIR ENFORCEABILITY

There are broadly four categories of Exit Rights that are most resorted to by investors:

1. Initial Public Offering ("IPO")

An IPO refers to the process of selling of securities to the public in the primary market for the first time. An IPO allows

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a company to raise equity capital from public investors. The transition from a private to a public company can be an important time for private investors to fully realize gains from their investment. An IPO is one of the largest sources of funds with long or indefinite maturity for the company. An IPO also greatly increases the credibility and publicity that a business receives.

When the company makes its first IPO to the public, the relationship is directly between the company and investors, and the money flows to the Company as its "Share Capital". Shareholders thus become owners of the Company through their participation in the Company's IPO and have ownership rights over the company. The shareholders of the Company are free to exit their investment through the secondary market. An IPO is generally considered as the most attractive Exit strategy for promoters and investors alike, because it leads to free transferability of shares besides infusion of additional capital from the national and international markets.

Enforceability:

Typically, the decision to go for an IPO is market-driven and strategic. However, given the mutual benefits for investors and promoters alike, this option is generally negotiated under the SHA as the first mode of Exit. Since the success of an IPO is heavily dependent on prevailing market conditions and other external factors, SHAs often require promoters and the company to make "best efforts", "reasonable efforts", "reasonable best efforts" or "every effort" to go public, as opposed to imposing a hard coded obligation on them, once the defined Exit period within the SHA has expired.

Some guidance on the manner in which these terms are interpreted may be taken from Indian jurisprudence on the interpretation of "best efforts" and "reasonable best efforts" clauses within general contracts and arbitration agreements. For instance, in *Smt. Manika Seth v. Sett Iron Foundry*² the Calcutta High Court referred to the English case of *Rhodia International Holdings Ltd. & Rhodia UK Ltd. v. Huntsman International LLC*,³ to hold that "reasonable efforts" requires an obligated party to undertake **one reasonable course/effort** towards discharging a specified obligation, while a "best efforts" clause requires an obligated party to undertake **all reasonable efforts available** in respect of an obligation. The Calcutta High Court has further held that the term "best efforts" may be equated with "every efforts". In the United States of America, the court has laid down a standard to assess how "best efforts" have been deployed in a specific case, and has held that this will depend entirely on the "capabilities and circumstances" of the party on which the obligation has been laid, and that "best efforts" shall require indication of an attempt to perform an obligation in line with the principles of the contract.⁴ In Canada, courts have held that "best efforts" or "commercially reasonable best efforts" will not require parties to perform actions which are against their economic interests,⁵ with an identical stance being adopted in United Kingdom.⁶ While these cases may not directly be suitable in the Indian context, they are suggestive of a general intent across jurisdictions that: (i) "best efforts" obligates parties to undertake all reasonable efforts available in respect of an obligation; and (ii) the determination of such efforts is to occur on a case-by-case basis.

Accordingly, the specific enforcement of an IPO clause in India may likely depend on the extent of the obligation imposed on the company and promoters within the clause. It is however clear that the standards imposed by "best efforts" and "every efforts" are higher than a "reasonable" effort. In the event that the obligation to provide an Exit by way of an IPO is disputed, then depending on the language of the contract, the company and promoters backing the obligation may have to demonstrate either "best efforts" or "every effort" expended to provide an IPO or "reasonable efforts" to explore at least one viable method of providing an IPO which has not fructified. While the standard of proof that may have to be applied for a "reasonable best efforts" clause is unclear, in lieu of the presence of the term "best efforts", it is likely that the evidentiary burden to be discharged will be higher. Conversely, an investor disputing a "best efforts" or "every efforts" clause will simply have to demonstrate that at least one available method/ mechanism to consummate the IPO has not been considered by the company and promoters. Further, any dispute pertaining to a "reasonable efforts" clause will have to demonstrate that the method adopted by the company or promoters was: (a) not in accordance with the format contemplated within the SHA; or (b) not actually consummated by them at all.

Recommendations for drafting IPO clauses:

- Parties must deliberate on the stringency of the requirement of going public, and impute an "efforts" standard accordingly. For investors, mapping the scope of obligations within the clause with their internal intended timelines for retaining the investment in the company may also be helpful. It is equally important, however, to acknowledge that there could be an impact of prevalent market conditions and regulatory environment may lead to an un-conducive set up for a company going public, and accordingly the IPO route may not be adopted.
- Additionally, it may be beneficial for investors to negotiate terms which provide them with a strategic advantage during the IPO – such as a priority in the order for offer of shares for sale and veto rights on procedural aspects concerning the IPO. However, it is important to note that none of these will necessarily guarantee direct enforcement of an IPO clause as an Exit Right. These shall merely serve as safeguards guaranteeing more control and involvement of an investor during the IPO process.

2. Third Party Sale, Trade Sale and Strategic Sale

The sale of the securities held by an investor to a third party (referred to as the 'third party sale'), is another common exit option negotiated by investors under the SHA, in which case, the existing shareholders of the company continue to retain their respective shares in the company.

A strategic sale is a specific form of Exit Right which requires the company or promoters to sell the entire share capital of the company (alongside the investor) to a strategic acquiror (typically, a person operating within the same sector as the company who is seeking strategic synergies from such acquisition). A strategic sale may be particularly onerous for the promoters as they lose control of the company in favour of an acquiror who may opt to operate the business differently from how the promoters have run it thus far.

Lastly, another common variation of this Exit Right is a trade sale, which involves sale of substantially all the assets and business of the company to a third party. In trade sales, the third party acquiror is often identified by independent merchant bankers of repute.

Enforceability:

While these clauses can be kept broad in order to accord flexibility to negotiate with the third party at a later date, in the interest of the investor and to avoid any room for an alternate interpretation, it is important to lay down in the SHA, the specifics in relation to the manner and conduct of such third party sale/ trade sale/ strategic sale including the trigger event, price range, terms and conditions on which such Exit will be made available to the investor.

In terms of enforceability of this clause against the company/ promoters, the investors are always faced with this debate on whether the management and promoters can influence/ guarantee the terms of the sale that will be provided by the third-party purchaser at a later point in time and therefore whether specifying terms of such Exit in the SHA is beneficial.

It is often seen that such strategic sale or trade sale is prone to internal conflicts between the existing investors of the company, since they may have different exit timelines and expectations from the process. It is therefore important to have all shareholders sign up to the SHA where the terms and conditions of Exit is captured so as to avoid questions arising in the future on the validity of exercise of this Exit Right.

Recommendations:

- The obligation to facilitate this mode of Exit should be jointly and severally on the Company and the Promoters. In order to provide additional comfort to the investor on the terms of sale, the clause may be drafted to include the following: (i) promoters/ company to solicit only such third party purchasers, who are “eligible persons” and do not violate the sanctions/ internal policies (draft of such policies may also be annexed to the SHA to avoid ambiguities) of the exiting investor; (ii) mode of payment (i.e. all cash consideration or otherwise); (iii) payment terms, whether investor would prefer a one time settlement over deferred consideration (to the extent permitted by law); (iv) the extent of representations and warranties that will be provided by the investor to the third party purchaser (which, in most cases, would extend only to fundamental representations on the title and authority of the exiting investor with respect to the sale securities; (iv) extent of indemnification obligation of the investor (which should extend, if at all, only to breach of the title representations provided by the investor).

If the clause is well drafted to include the specifics as suggested above, the investors may be able to avail specific performance of this obligation in the manner prescribed in the SHA, from the company and/ or the promoters.

3. Drag Along Right

A drag along right provides the holder (also called as the dragging shareholders) the right to require (and obligate) other existing shareholders (also called as the dragged shareholders) to sell their shares to a third party purchaser at the same price and on the same conditions at which the right holder sells its shares. This provision tends to protect the majority investors from minority shareholders that may want to obstruct their exit in case a third party purchaser wishes to purchase a substantial portion of the company (which is larger than the shareholding of the existing majority investors). This is usually the last resort in the Exit waterfall, and once all other Exit options fail, the investors have the right to drag the promoters and all other shareholders of the company.

The pricing and valuation of a drag sale is no different from other modes of sale and will be subject to applicable law (which, in case of a non-resident exiting investor will be governed by the Foreign Exchange Management Act's Non-Debt Instrument Rules, 2019).

Enforceability:

While enforceability of drag along rights are not widely tested in Indian courts, these rights are not *per se* unenforceable. Disputes may arise in respect of whether the mechanism and modalities (including the trigger events) governing the drag along right, have been exercised in the manner contemplated in the transaction documents.

In our experience, one of the concerns that may emerge in relation to enforceability of a drag along right is the remedies available to a drag right holder in case the dragged shareholders refuse to tender their shares in accordance with the procedure contemplated within the drag along clause. In such cases, an investor seeking Exit may be severely prejudiced and this situation may be particularly detrimental to institutional investors who are seeking this exit closer to the expiry of their fund life. The underlying SHA will generally not prescribe any mechanism (other than specific performance) to seek a remedy. While the exiting investors will otherwise always have a right to sell their shareholding (in isolation to the other shareholders) to a third party, the question remains as to the viability of including drag along rights in the SHAs, if such rights cannot be enforced against the dissenting shareholders.

Additionally, foreign jurisprudence does also provide some guidance on other potential enforceability concerns that may arise in the context of drag along rights. In a case before the Court of Chancery of Delaware,⁷ it was held that drag along rights are not enforceable if the procedure stipulated within the SHA is not complied with. Here, the clause required majority shareholders to furnish a notice to the minority shareholders informing them about the implementation of drag along rights, which was done only after exercising the drag along rights.

Recommendations:

- In order to reduce any conflicts that may arise with the dragged shareholders, the clause should specify in abundant detail that all dragged shareholders shall: (i) be obligated to transfer alongside the drag right holder, upon invocation of a drag right; (ii) provide all representations and warranties (backed by appropriate indemnities) as may be customarily required by the third party purchaser; (iii) specify the delivery timeline (i.e. the time within which shares shall be tendered to the third party purchaser).
- Although not common in the Indian context, the Investors may consider specifying the consequences for a shareholder refusing to comply with a drag along clause. We note that in jurisdictions such as France the transaction documents prescribe payment of a penalty in case of non-compliance of such a clause by the dragged shareholders.⁸

4. Put Options

Put options are contracts which provide an investor with the right to demand the sale of the shares held by them, at a fixed price within a specified time, or upon the occurrence of defined events (for instance, failure to receive exit

through IPO, a “material breach” of obligations, etc.). Since these options guarantee some form of return on the initial investment, they are preferred by investors as a preferred mode of exit.

Enforceability:

Typically, there have been no concerns with the enforceability of put options in the context of private unlisted companies. Disputes may potentially arise between existing investors only in relation to: (i) the manner of enforcement of the put option; (ii) whether the conditions leading to the trigger of the put option have been met; and (iii) the manner in which the price to be provided to the investor through exercise of this mechanism is to be calculated.

There have been some concerns with put options that provide an “assured rate of return” to a foreign investor upon their exercise. Previously, the SEBI and Reserve Bank of India (“**RBI**”) have questioned the enforceability of such put options by taking the view that options are speculative in nature and thus become illegal “forward contracts” under the Securities Contracts (Regulation) Act, 1956 (“**SCRA**”).⁹ The RBI noted that option contracts, especially put options in favor of non-residents were treated as redeemable instruments providing a guarantee of “assured returns”, and accordingly not permitted under the FDI policy.¹⁰ However, steps have been taken by both the regulatory bodies to liberalize this stance. For instance, SEBI via its notification dated October 3, 2013¹¹, has permitted contracts in shareholders agreements or articles of association of companies/ bodies corporate containing an option for purchase or sale of securities, subject to the following conditions being met: (i) the title and ownership of the underlying securities is held continuously by the selling party for at least one year from the date of execution of the contract; (ii) the consideration payable complies with all applicable laws; (iii) the contract is settled through actual delivery of the underlying securities; and (iv) the contract itself is in compliance with Foreign Exchange Management Act, 1999 (“**FEMA**”). Separately, the RBI via its circulars, dated 9 January 2014¹² and 15 July 2014¹³ has also permitted options issued to non-residents by unlisted companies so long as there is no guarantee of an assured return or exit price at the time of undertaking the investment.

Additionally, the question of whether a put option provides “assured returns” has been subject to discussion before the Delhi High Court. In *Cruz City 1 Mauritius Holdings v. Unitech Ltd.*,¹⁴ the parties and their subsidiaries had entered into an agreement for the development of a real estate project through a joint venture company. Cruz City exercised its put option which required Unitech’s subsidiaries to purchase its shares because the project was delayed. The Delhi High Court held that the put option providing an assured rate of return was enforceable and not violative of the FEMA because it was exercisable only on breach of the contractual assurances provided to the foreign investor, in this case being the delay in commencement of the project. Similarly, in *NTT Docomo Inc. v. Tata Sons Ltd.*,¹⁵ the clause required exercise of the put option if Tata Teleservices Limited failed to achieve certain performance targets. This clause was held to be enforceable because there was no guaranteed exit price within the SHA, making the option more like a downside protection and not an “assured return” under FEMA. After these cases, the general perception has been in favor of enforcement of put option contracts without assured returns that are triggered after specific exercise of the option by a party.¹⁶ Thus, Indian Courts are likely to enforce put options if they have no guarantee of assured returns for the investor.

Recommendations:

- In order to ensure that the put option is validly exercised, investors must ensure adherence to the procedure prescribed in the SHA to avoid any ambiguities in relation to the manner of calculation of the put price.
- The conditions to trigger a put option must be capable of clear determination. For instance, in case one of the triggers of a put option is the material breach of an agreement by a promoter, the method of determination of such “materiality” must also be clearly laid down in the SHA in order to ensure that such subsequent resort to the put option is not challenged.

CONCLUSION

Even before investors finalise their investment in a company, they plan exit options to ensure a seamless transition out of the company. In today’s day and age, exits are no longer events that occur only on the failure of a company to perform up to initial expectations. While Indian company law jurisprudence on enforceability of specific investor exit rights is scant, drafting appropriate safety nets based on best practices can help investors secure their exit strategies in other ways within the transaction documents.

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You can direct your queries or comments to the authors.

¹We have analysed this conundrum in our article available at: <https://www.nishithdesai.com/generateHTML/6153/4>.

²Judgment dated 28 July 2020, in Arbitration Petition No. 80 of 2020 (Calcutta High Court).

³(2007) EWHC 292 (Comm).

⁴*Carlson Distributing Co. v. Salt Lake Brewing Co.* 95 P.3d 1171 (Utah Ct. App. 2004).

⁵*Eastwalsh Homes Ltd. v. Anatal Developments Ltd.*, 1993 CanLII 3431 (ON CA).

⁶*Terrell v. Mable Todd & Co. Ltd.* (1952) 69 RPC 234.

⁷*Halpin v. Riverstone National, Inc.*, C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015).

⁸See, for example, the decision of the Paris Court of Appeals in CA Paris 21 December 2001, No. 01/09384, [2002] Bull. Joly Sociétés 509 9, comment H. Le Nabasque. See also M. Philippe Clin v SA Canab et al., CA Versailles 16 October 2007, No. 06/06328.

⁹See, for example, public takeover of *Caim India Limited* where the parties had entered into put and call options arrangements. SEBI was of the view that put option call option arrangements and the right of first refusal do not conform to the requirements of a “spot delivery contract” nor with that of a “contract of derivatives” as provided under Section 18-A of the SCRA and, therefore, are illegal.

¹⁰Regulation 2(v) Explanation a, Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017.

¹¹No. LAD-NRO/GN/2013-14/26/6667, Securities and Exchange Board of India Notification, 3rd October 2013, Notification under Section 16 and 28 of Securities Contracts (Regulation) Act, 1956.

¹²RBI/2013-2014/436 A.P. (DIR Series) Circular No. 86 dated 9th January 2013.

¹³RBI/2014-15/129 A.P. (DIR Series) Circular No. 4 dated 15th July 2014.

¹⁴(2017) 239 DLT 649.

¹⁵(2017) 241 DLT 65.

¹⁶*Edelweiss Financial Service Ltd v. Percept Finserve Pvt Ltd and Ors.*, 2019 (2019 SCC OnLine Bom 732), as affirmed by the Division Bench of the Bombay High Court in 2023 SCC OnLine Bom 319.

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