June 28, 2005

Legal Do's and Don'ts in Venture Capital Transactions

By Akil Hirani, Majmudar & Co., International Lawyers, India

1. GENERAL OVERVIEW

1.1 Economics and market structure of venture capital in India

Countries across the globe are realizing that it is not just the conglomerates and gigantic corporations that fuel economic growth any more. The essence of any economy today is small and medium enterprises. For example, in the US, companies with less than 20 employees create 50% of the exports, and companies with 500 or more employees create only 7%.[1] This growing trend can be attributed to rapid advances in technology in the last decade. Knowledge driven industries like infotech, health-care, entertainment and services have become the cynosure of bourses worldwide. In these sectors, it is innovation and technical capability that are big business-drivers. This is a paradigm shift from the erstwhile physical production and "economies of scale" model.[2]

Starting an enterprise though is never easy. There are a number of parameters that contribute to its success or downfall. Experience, integrity, prudence and a clear understanding of the market are among the sought after qualities of a promoter. However, there are other factors, which are beyond the control of the entrepreneur. Prominent among these is the timely infusion of funds. This is where the Venture Capitalist ("VC") comes in, with money, business sense and a lot more.[3]

VCs are professional money managers who provide risk capital to businesses. VCs come in many forms and specialise in different ways, but all share the common trait of making investments at early stage in privately held companies that have the potential to provide them a very high rate of return on their investment.[4] Private equity investments are essentially investments in more mature companies. Private equity firms focus on active investments and aim to acquire a large or controlling interest in companies

---

[1] *McKinsey & Company* - US Venture Capital Industry – Industry Overview and Economics (Summary Document), September, 1998.

[2] *Ernst & Young LLP, NVCA and American Entrepreneurs for Economic Growth* - The Job Creating Power of Venture Capital Financed Emerging Growth Companies, September, 1997.

[3] Steven P. Galante, Editor and Publisher, The Private Equity Analyst newsletter - An Overview of the Venture Capital Industry and Emerging Changes.

[4] *Mr Sudhir Sethi, Director, Walden-India* - Accessing Venture Capital Funds, June 1999.

with solid growth potential. As a result, private equity firms usually oversee, assist and, if necessary, redirect the company's activities or its management. Given the skilled and cost competitive manpower, technology, research and enterprise with proper environment and policy support, Indian companies have achieved rapid growth, particularly in the knowledge-based sectors.[5]

1.1.1 Venture capital funds in India

The Securities and Exchange Board of India ("SEBI") (Venture Capital Fund) Regulations, 1996 provide that a domestic venture capital fund can be structured either as a company registered under the Companies Act, 1956 ("Cos Act"), or as a trust under the provisions of the Indian Trusts Act, 1882 and the Indian Registration Act, 1908 or as a body corporate. A venture capital trust or company raises funds through issue of units. These funds are deployed for investment in knowledge-based companies having a high growth potential. Venture capital investments are based on well-chalked out plans, which include choosing the right investment candidate, evaluating the investment proposal and risks involved, negotiating the financial aspects of the deal and selecting an appropriate exit mechanism.

Interestingly, contrary to popular belief, the figures released by the Indian Venture Capital Association suggest that there was only a marginal decline in total amount of venture funding during the year 2001-02. The total quantum disbursed was US$ 1.1 billion during the year, a marginal decline from the disbursement of US$ 1.2 billion during 2000-01.[6]

Year	US Dollars (in Millions)
1996-97	20
1997-98	80
1998-99	250
1999-2000	500
2000-2001	1,200
2001-2002	1,100

In 2000, the SEBI announced the SEBI (Foreign Venture Capital Investor) Regulations, 2000 ("FVCI Regulations") enabling foreign venture capital

[5] Ibid.
[6] http://www.nasscom.org/artdisplay.asp?cat_id=61 accessed on October 15, 2002.

and private equity investors to register with SEBI and avail of certain benefits provided thereunder.

1.1.2 Venture capital funds and private equity funds

In India, there is a fundamental difference between a venture capital transaction and a private equity transaction. While VCs look to invest in innovative and sustainable ideas, which can be converted into a successful business, private equity players invest in established businesses. Unlike private equity players, VCs adopt a mentor approach. However, venture capital activity in early stage companies is at an all time low. Unfavourable market conditions and the lessons learnt from the dot-com crash have altered the traditional role of a VC. Indian VCs now seek to mitigate the risks involved by investing in established businesses with a revenue model. Thus, in practice, there is no difference between a modern day VC and a private equity player. The classic Silicon Valley definitions of venture capital funds and private equity funds do not hold good in the Indian context.

1.1.3 Investment trend in 2002

The year 2002 has witnessed a growth in venture capital investment in the services segment in India. Business process outsourcing has been a big favourite. Investments in software development companies have come second. The pharmaceutical sector has also seen some action, both in the areas of new drug research and clinical trials outsourcing. Media and entertainment companies have been another favourite of some private equity funds.

1.2 Legal Documentation

1.2.1 At the very beginning, the parties enter into a confidentiality and non-disclosure agreement to prevent leakage of ideas and concepts. If the deal fructifies, a share subscription or purchase agreement is entered into by the VC and investee company. Often, the shareholders of the investee company (including the VC) enter into a separate shareholders' agreement. The articles of association of the investee company are amended to provide for the understanding of the parties as embodied in the share subscription and shareholders' agreement.

1.2.2 Scope and content of the legal documentation

a) In India, documents are detailed. The share purchase agreement contains the quantum of shares being sold, the price, representations and warranties, indemnities (if required), tag along or drag along rights at exit and such other matters that are relevant to the transaction.

b) It is common to sign a Term Sheet, which may also be referred to as a Letter of Intent or a Memorandum of Understanding. The parties can choose whether to make a Term Sheet binding or not. In the absence of anything to the contrary, a Term Sheet can bind the parties. However, this rarely causes problems, for a Term Sheet typically contains several exit provisions.

c) Indian companies tend to use Silicon Valley precedents of share subscription agreements to the extent applicable to Indian law. All typical venture capital clauses, i.e., milestones, anti-dilution provisions, exit strategies, escrow clauses and valuation provisions, are included therein.

d) Shareholders' rights are the subject of serious negotiations. The VC typically seeks board representation depending on the quantum of stock being taken. Tag and drag along rights are very common. In addition, lock-in periods as regards the promoters' stock may also be included. As mentioned above, provisions in the share subscription agreement or the share purchase agreement are to be included in the articles of association so as to bind the company.

1.2.3 An agreement, represented by a legal document, is valid and binding on the parties thereto, if it is made by the free consent of the parties who are competent to contract, for a lawful consideration and with a lawful object. Other than the foregoing, there are no legal limitations to entering into VC transactional documents.

Under the Cos Act, share capital of a company can be of two kinds, namely, equity and preference.[7] Equity capital has been sub-divided into two categories, namely, shares with equal rights and shares with differential rights, as to dividend, voting or otherwise. Shares with differential rights can be created by following the rules prescribed by the Central Government, which are very rigid.

[7] See section 86 of the Companies Act, 1956, as amended in 2000.

Non-performance by any party of share subscription or shareholders' agreement can give rise to a cause of action for specific performance of the breached covenant. In addition, breach of a representation gives rise to a cause of action for repudiation of the contract and damages.

2. PROTECTING INVESTOR'S RIGHTS AND COMPANY'S INVESTMENTS

2.1 Due Diligence

2.1.1 It is not unusual for venture capital funds/companies to set up an "investment screen." The screen is a set of qualitative (sometimes quantitative criteria such as revenue are also used) criteria that help venture capital funds/companies to quickly decide on whether an investment opportunity warrants further diligence. Screens may be elaborate and rigorous or specific and brief. The nature of screen criteria is also a function of the investment focus of the firm at that point.

An investment proposal, subject to a detailed due diligence process, encompasses evaluating the management team, reference checks and technology audits. To ascertain the quality of the entrepreneur, VCs conduct thorough background searches. Further, company searches in the office of the Registrar of Companies are also conducted. VCs insist on a comprehensive business plan which can help them evaluate possible risks and the expected returns. Once the VC is satisfied with the entrepreneur's credentials, he proceeds to appraise the characteristics of the product, its market and the technology. The due diligence process may also involve legal due diligence on the company, whereby the VC ascertains if the stock has been properly authorized and issued, whether the company owns the necessary intellectual property rights, and whether the material contracts of the company are in order.

2.1.2 Non-disclosure and Confidentiality Agreements

A due diligence review by the VC necessitates access to confidential information of the target company. In order to maintain the confidentiality of such information and to prevent unauthorized disclosures, the target company insists on the VCs signing a non-disclosure and confidentiality agreement. In order to enforce such agreements, adequate proof of breach or proposed breach must be adduced. Though a court may grant an interim injunction urgently, a decree granting damages may take a long time.

In the event that no confidentiality agreement is executed, an injunction may be given, in clear cases, under principles of equity.

2.2 Valuation

2.2.1 The investment valuation process is an exercise aimed at arriving at 'an acceptable price' for the deal. Typically, in countries where free pricing regimes exist, the valuation process goes through the following steps:

a) Evaluating future revenue and profitability;

b) Forecasting likely future value of the firm based on experienced market capitalization or expected acquisition proceeds depending upon the anticipated exit from the investment;

c) Targeting an ownership position in the investee firm so as to achieve desired appreciation on the proposed investment. The appreciation desired should yield a hurdle rate of return on a Discounted Cash Flow basis;

d) Symbolically the valuation exercise may be represented as follows: NPV = [(Cash)/(Post)] x [(PAT x PER)] x k, where

NPV = Net Present Value of the cash flows relating to the investment comprising outflow by way of investment and inflows by way of interest/dividends (if any) and realization on exit. The rate of return used for discounting is the hurdle rate of return set by the venture capital investor

Post = Pre + Cash.

Cash represents the amount of cash being brought into the particular round of financing by the venture capital investor.

"Pre" is the pre-money valuation of the firm estimated by the investor. While technically it is measured by the intrinsic value of the firm at the time of raising capital, it is more often a matter of negotiation driven by the ownership of the company that the venture capital investor desires and the ownership that founders/management team is prepared to give away for the required amount of capital.

PAT is the forecast Profit after tax in a year and often agreed upon by the founders and the investors (as opposed to being 'arrived at' unilaterally). It would also be the net of preferred dividends, if any.

PER is the Price-Earning multiple that could be expected of a comparable firm in the industry. It is not always possible to find such a 'comparable fit' in venture capital situations. That necessitates, therefore, a significant degree of judgment on the part of the venture capital to arrive at alternate PER scenarios.

"k" is the present value interest factor (corresponding to a discount rate 'r') for the investment horizon.

Another popular variant of the above method is the First Chicago Method (FCM) developed by Stanley Golder, a leading professional venture capital manager. FCM assumes three possible scenarios – "success," "sideways survival" and "failure." Outcomes under these three scenarios are probability weighted to arrive at an expected rate of return:

In reality, the valuation of the firm is driven by a number of factors. The more significant among these are:

a) Overall economic conditions: A buoyant economy produces an optimistic long- term outlook for new products/services and, therefore, results in more liberal pre-money valuations.
b) Demand and supply of capital: When there is a surplus of venture capital chasing a relatively limited number of venture capital deals, valuations go up. This can result in unhealthy levels of low returns for venture capital investors.
c) Specific rates of deals: Founder's/management team's track record, innovation/ unique selling propositions (USPs), the product/service size of the potential market, etc., affects valuations in an obvious manner.
d) The degree of popularity of the industry/technology in question also influences the pre-money: Computer Aided Skills Software Engineering (CASE) tools and Artificial Intelligence were one time darlings of the venture capital community that have now given place to biotechnology and retailing.
e) The standing of the individual venture capital: Well established venture capitals who are sought after by entrepreneurs for a number of reasons could get away with tighter valuations than their less known counterparts.

f) <u>Investor's considerations could vary significantly</u>: A study by an American venture capital, VentureOne, revealed the following trend. Large corporations who invest for strategic advantages, such as access to technologies, products or markets, pay twice as much as a professional venture capital investor, for a given ownership position in a company but only half as much as investors in a public offering.

g) Valuation offered on comparable deals around the time of investing in the deal.

2.2.2 Typically, once a value is fixed, it is not subject to change. Entrepreneurs rarely agree to covenants giving advantages to VCs if valuation changes over a period of time.

2.3 Representations and Warranties

In a venture capital transaction, the VC enters into a share subscription agreement to purchase equity of the target company. Such an agreement includes negotiated representations and warranties.

2.3.1 Typical representations and warranties of the target company would be that:

a) The company is duly organised, validly existing and in good standing under Indian law and has the requisite corporate power, licence, etc. to conduct its business.

b) The company has the authority to enter into the share subscription agreement, and all necessary corporate action will be taken by the company and its officers, prior to closing, so as to bind the company.

c) Execution of the share subscription agreement will not contravene the terms of any organizational document or create an encumbrance under any contractual obligation or requirement of law applicable to the company.

d) The company holds the legal and beneficial title to the shares. The shares have been duly authorised and issued. Except as set forth in the share subscription agreement, there are no other outstanding preemptive or other rights, plans, options, warrants, conversion rights to purchase and acquire shares from the company.

e) No shareholder of the company has any right of first refusal or other preemptive right, in connection with the shares issued under the agreement.

f) The company has good title to all properties owned by it.

g) All the material contracts of the company are in order.

h) The company owns the intellectual property rights necessary to conduct its business. (Often, intellectual property, necessary to conduct the business of a start-up company, is owned by one of the founding shareholders. In such a case, the company cannot build any value or gain strength on the basis of its intellectual property. To avoid this, it is desirable that the intellectual property is assigned by the founding shareholder to the company.)

i) The company has complied with all employment laws and neither the company nor its employees are bound by any non-compete or confidentiality agreements relating to the present or proposed business activities of the company.

j) All employees and consultants of the company have executed a proprietary information and inventions assignment agreement.

k) There is no pending or threatened litigation against or by the company.

l) All legal requirements have been complied with, and the company and its subsidiaries have filed their tax and other returns.

m) The necessary government and/or third party approvals have been obtained.

n) The company and its subsidiaries have no material liabilities other than those disclosed in their financial statements submitted to the venture capital investor.

Under the Cos Act, a company is a legal person having a separate and independent existence other than its shareholders. Since a company has the capacity to contract, the foregoing representations and warranties can be provided by the company itself. The Cos Act makes it an offence to fraudulently induce persons to invest money by making false, deceptive and

misleading statements, promises, forecasts, etc. Any person who is responsible for such inducement is punishable with imprisonment for a term of up to five (5) years, or with fine which may extend to Rs. 1,00,000 (US$ 2200). While the present version of the Cos Act does not provide for a minimum imprisonment term, the Companies (Amendment) Bill 2003, which is currently pending in Parliament, proposes to introduce a minimum imprisonment term of six (6) months. According to the proposal, the responsible person shall also be liable to pay a penalty not less than twice the amount raised on account of the relevant fraudulent action. These provisions act as a deterrent and present promoters, etc. from making untrue and deceptive statements to obtain capital.[8]

Standard representations and warranties of the venture capital investor would be that:

a) The shares are being acquired for purpose of investment and not for the purpose of sale or distribution.

b) The investor has the capacity to enter into and perform its obligations under the agreement.

c) The agreement and other transaction documents have been duly authorized by all necessary actions, and do not contravene the terms of any organizational document of the investor.

d) The investor is solely responsible for the due diligence investigation of the company.

e) The investor has acted solely in his own interest and not as an agent of the company.

f) All legal requirements have been complied with, and the requisite government or third party approval, have been obtained.

As mentioned above, shares are classified into equity shares and preference shares. Preference shares carry with them a preferential right to receive a fixed dividend. When a company is wound up or its capital is repaid, the preference shareholders get preferential treatment in respect of repayment of paid-up capital. Equity shareholders may possess voting rights or may have differential rights as to dividend, voting, etc. The representations and

[8] See section 68 of the Companies Act, 1956, as amended in 2000.

warranties for preference and equity shareholders may accordingly vary. However, the representations and warranties do not vary with the stage of investment.

2.4 Key Personnel

The fate of a start-up company largely depends on its ability to recruit and retain talented staff. To convert an idea into a successful business, the entrepreneur must be supported by a team of professionals, who are adept at business. Employee stock option schemes ("ESOPs") are often used as a tool to motivate employees and to woo fresh talent. The SEBI and the Income-tax authorties have issued detailed guidelines in respect of the regulatory and tax treatment of ESOPs. If applicable, these guidelines have to be followed. Most companies enter into employment contracts with their employees. The duration depends on the company's business model.

Very often, the brain behind the idea may not be the perfect chief executive officer ("CEO"), but insists on playing this role. The CEO, who is the principal officer of the organisation, must be a true leader, who can brave the challenges involved in setting up a new venture. Though it is wise to allow the right candidate to take the company further, this is hardly the case in India. Irrespective of the expertise and competence level, almost every start-up company is headed by its founding shareholder. Since there is a dearth of professional CEOs, VCs don't make a big issue about this.

2.5 Financials and Liquidity

The board of directors of every company is required to present the company's financial statements to the shareholders at every annual general meeting.[9] Besides this statutory right, the share purchase agreement entered into between the VC and the target company may provide for certain information rights to the VC. This may entitle the VC to receive monthly or quarterly financial statements of the company.

VCs usually insist on certain rights and protections in respect of liquidity and future or continuous investment, such as liquidity preference rights, rights of first refusal (preemptive rights), anti-dilution protection, etc.

Liquidity preference rights: VCs demand a preferential treatment in respect of payments to be made at the time of liquidation of the company.

[9] See section 210 of the Companies Act, 1956, as amended in 2000.

However, these are subject to the rights of employees and government authorities, under the Cos Act.

Anti-dilution protection: VCs insist on measures to ensure that their interest in the company is protected against unreasonable dilution. In almost all venture capital transactions, preemptive rights, which provide anti-dilution protection to the investors, are common. If the company issues additional stock, the VCs are given the opportunity to purchase the requisite number of shares to maintain their percentage ownership in the company.

Further, if shares are issued to other investors at lower prices, the VC will seek anti-dilution protection by adjusting the ratio at which the preferred stock held by it will be converted into common stock.

2.6 Exit Strategy

The exit strategy is worked out by experts on the basis of what is most profitable and suitable to both the VC and the investee. Out of the several exit routes available to VCs, the most popular are sale to another VC ("Strategic Sale") or sale at the time of initial public offering ("IPO"). There are several applicable laws, which facilitate exits by domestic and foreign VCs, registered with the SEBI.

Normally, in case of exits involving transfer of Indian shares held by a non-resident to a resident, the exit price is the price of the shares on the stock exchange (if the shares are listed) or is linked to the net asset value of the shares (if the shares are unlisted). The norms prescribed by the Reserve Bank of India ("RBI") to value investments held by a foreign VC are in sharp contrast to this general principle. Under these norms, a foreign VC can sell shares, convertible debentures, units or any other investment held by it in a domestic venture capital fund or undertaking, at a price that is mutually acceptable to the buyer and the seller. Thus, a foreign VC, who seeks to make an exit by selling his shares through the Strategic Sale or buy-back route, is not subject to any exit price restrictions.

Further, the Securities and Exchange Board of India (Substantial Acquisition and Takeovers) Regulations, 1997 (the "Takeover Regulations") make it mandatory for an acquirer of 15% or more of the shares or voting rights in a company to make a public offer to the other shareholders to buy at least 20% of the voting capital of the company. The Takeover Regulations are inapplicable in cases of transfer of shares by domestic and foreign VC funds, registered with SEBI, to promoters of a

venture capital undertaking, in which their funds are invested. Therefore, promoters, who buy their company's shares from an existing venture capital fund, are not required to make a public offer to buy similar shares possessed by the other shareholders.

Under the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000 (the "SEBI DIP Guidelines"), the pre-issue share capital of an unlisted company, which seeks to make an IPO, is locked-in for a period of one (1) year from the date of commencement of commercial production or the date of allotment, whichever is later. This lock-in requirement is inapplicable to domestic and foreign venture capital funds registered with SEBI. However, the shares acquired by registered domestic and foreign venture capital funds by way of preferential allotment of shares of a listed company shall be subject to a lock in period of one (1) year.

2.7 Corporate Governance

Typically, a venture capital investor is appointed as a director on the board of directors of the company. The articles of association of the company or the shareholders' agreement, may grant veto rights to VCs, who are represented on the board. In such cases, the interests of the founding shareholders can be safeguarded by ensuring that they constitute the majority on the board. The Cos Act also contains provisions to protect the minority shareholders from the influence of the majority. For instance, under section 235 of the Cos Act, the Registrar of Companies can *suo moto*, on receipt of information disclosing an unsatisfactory state of affairs of a company or on receipt of an application from the specified number of shareholders of a company, initiate an investigation into its affairs. Further, the minority shareholders can invoke the provisions of sections 397 and 398 of the Cos Act, dealing with oppression of the company's members and mismanagement of its affairs, and apply to the company law board ("CLB") for an appropriate order. The CLB will soon be dissolved and replaced by the National Company Law Tribunal ("NCLT"). Persons aggrieved by an order or decision of the NCLT may appeal to the Appellate Tribunal, which will be established together with the NCLT.

The appointment of a director is subject to the provisions of sections 252 to 323 of the Cos Act. The relevant provisions of the Cos Act relating to liabilities, appointment, qualifications, retirement etc. of a director have been discussed below:

Liabilities of a director

An officer of a company who has committed a default under the Act, may be prosecuted in case of any violation if, at the time of contravention, he was in charge of management and responsible to the company for the conduct of its business. Under section 5 of the Act, the managing director, whole-time director, manager and the secretary are deemed to be officers in default and in case of board managed companies, all the ordinary directors, in the absence of specification of some director or directors as officers responsible, are deemed to be officers in default. The Companies (Amendment) Bill 2003 proposes to increase the type of officers to be held responsible. According to the proposal, any director having given consent or conniving to contravene the provisions of the Act, the chief accounts officer, every employee holding two (2) percent or more of the equity share capital and receiving a higher remuneration than the managing or whole-time directors, the share transfer agents, the bankers, the registrars to the issue and the merchant bankers involved shall also be deemed to be officers in default.

Default in reference to an officer means the default committed by the officer during his tenure. Furthermore, it is not necessary to prove that the default has been committed by the officer knowingly or wilfully. In order that the conviction of an officer of a company may be sustained, the only thing the prosecution has to prove is that the particular officer knowingly and wilfully authorised or permitted the default.

Minimum number of directors, appointment and retirement

The minimum number of directors for a private company is two (2), while a public company must have at least three (3) directors. While the Companies (Amendment) Bill, 2003 intends to change the minimum number of directors for a public company to seven (7), if the paid-up capital and free reserves are at least Rs. 50,000,000, or if the turnover amounts to at least Rs. 50,000,000, there are no changes envisaged for private companies.

At least two-thirds of the directors of a public company or a private company, which is a subsidiary of a public company, are to be appointed by the company in a general meeting. The directors so appointed retire by rotation at every annual general meeting. The appointment of the remaining directors is governed by the articles of association. In the absence of any provisions in the articles of association, the company will continue the appointment of such remaining directors as well as the retiring directors.

In the case of other private companies, the appointment of directors is in a general meeting, unless the articles of association contain a provision in this regard.

Managing and whole time directors

Every public company, or a private company, which is a subsidiary of a public company, having a paid-up share capital of Rs. 50,000,000 must appoint a managing or whole-time director or manager.

The appointment of a person as a managing or whole time-director or manager is subject to Central Government approval, unless the appointment is by a shareholders' resolution in a general meeting and is in compliance with conditions relating to minimum age, residential status, remuneration, etc. set out in schedule XIII to the Cos Act. Such a person must also not be imprisoned or fined, in respect of any of the offences listed in the schedule.

Disqualifications

Only an individual and not a body corporate, association or firm can be appointed as a director. A person can be disqualified from being appointed as a director on grounds like unsoundness of mind, insolvency, commission of offences involving moral turpitude and failure to pay any call in respect of the shares of the company. The Companies (Amendment) Bill 2003 proposes to add as further reasons for disqualification, the conviction for any default punishable with imprisonment under the Cos Act and the failure to acquire the percentage of shares necessary in the relevant class of companies. The court can exercise its power to restrict fraudulent persons from managing companies and pass an order disqualifying a person for appointment as director on this ground.

A person, who is a director of a public company, which has not filed its annual returns and accounts or has failed to redeem debentures, pay dividend, deposit or interest thereon is disqualified from being appointed as a director, for a period of five (5) years from the date of breach.

In the case of a private company, which is not a subsidiary of a public company, the articles of association may contain additional grounds other than those laid down in the statute to disqualify a person.

Restrictions on number of directorships

No person can hold office at the same time as director in more than 15 companies. There is a proposal in the Companies (Amendment) Bill 2003 to reduce the permitted number of directorships to 10, if the person holds office as a managing director or whole-time director in any other company. However, in calculating the number of directorships, a private company which is not a subsidiary or a holding company of a public company, an unlimited company, a non-profit or non-dividend paying association and a company, in which such a person is acting as a director in the absence or incapacity of some other director is not taken into account.

Share qualification

In the case of a public company, if the articles of association require a director to hold a specified share qualification, he must obtain such qualification within two (2) months of his appointment. The nominal value of the shares must not exceed Rs. 5000 or the nominal value of one share, if it exceeds Rs. 5000. The provisions relating to share qualification do not apply to a private company, unless it is a subsidiary of a public company.

3. Regulatory Issues

3.1 The Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 and the Securities and Exchange Board of India (Foreign Venture Capital Investors) Regulations, 2000 (together the "SEBI Regulations")

The SEBI Regulations govern venture capital transactions in India. The SEBI will register a domestic venture capital fund or a foreign venture capital investor, proposing to carry on venture capital activity in India, subject to the fulfillment of the eligibility criteria and other requirements contained in the SEBI Regulations. Registration with SEBI is not mandatory, though. Registration confers several benefits, including tax concessions and hence, is beneficial. The SEBI Regulations prescribe certain conditions and restrictions, applicable to investments in venture capital undertakings, which are as follows:

a) The domestic venture capital fund or the foreign venture capital investor, as the case may be, must disclose the investment strategy to SEBI.and must achieve the investment conditions by the end of its life cycle.

b) Foreign venture capital investors can invest in venture capital undertakings directly or through approved domestic venture capital funds. There is no limit to the extent of foreign contributions to domestic venture capital funds.

c) Investment in one venture capital undertaking is subject to an investment limit of 25% corpus of the fund.

d) A domestic venture capital fund cannot invest in associated companies. This restriction is inapplicable to foreign venture capital investors.

e) At least 66.67% of the investible funds must be invested in unlisted equity shares or equity linked instruments.

f) Not more than 33.33% of the investible funds can be invested by way of:

    (i) subscription to initial public offer of a venture capital undertaking, whose shares are proposed to be listed.
    (ii) debt or debt instrument of a venture capital undertaking in which the domestic venture capital fund or foreign venture capital investor has already made an investment, by way of equity.
    (iii) preferential allotment of equity shares of a listed company subject to lock-in period of one year.
    (iv) the equity shares or equity linked instruments of a financially weak company or a sick industrial company (as explained in the SEBI Regulations) whose shares are listed.

The VCs cannot invest in undertakings engaged in non-banking financial services except those registered with the Reserve Bank of India and have been categorized as Equipment Leasing or Hire Purchase Companies, gold financing except those engaged in gold financing for jewellery, activities not permitted under the Industrial Policy of the Government of India and in any activity, which may be specified by the Board in consultation with the Government of India.

3.2 Favoured structure for the target company

According to the SEBI Regulations, the target company must be an unlisted domestic company. Therefore, to comply with the SEBI Regulations and avail of favourable legal consequences, the target company must possess the characteristics of a private limited company.

3.3 IPOs by unlisted start-up companies

In order to make an IPO, an unlisted company must satisfy the following conditions:

a) it must have net tangible assets of at least Rs. 30,000,000 (Rupees thirty million) in each of the preceding three (3) full years (of 12 months each), of which not more than 50% are held in monetary assets; if more than 50% of the net tangible assets are held in monetary assets, the company must have made firm commitments to deploy such excess monetary assets in its business/project;

b) it must have a net worth of at least Rs. 10,000,000 (Rupees ten million) in each of the preceding three (3) full years (of 12 months each);

c) it must have a track record of distributable profits for at least three (3) out of the immediately preceding five (5) years;

d) in case the company has changed its name within the last year, at least 50% of the revenue for the preceding full year must have been earned by the company from the activity suggested by the new name; and

e) the aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e. offer through offer document and firm allotment and promoters' contribution through the offer document), must not exceed five (5) times its pre-issue net worth as per the audited balance sheet of the last financial year.

There are two ways to make an IPO even though the above conditions are not satisfied:

The first possibility is to make the IPO through a book-building process, provided that fifty percent (50%) of the issue size is allotted to qualified institutional buyers. According to the SEBI DIP guidelines, qualified institutional buyers include, inter alia, public financial institutions,

scheduled commercial banks, mutual funds, foreign institutional investors registered with SEBI and venture capital funds registered with SEBI.

The other possibility is to provide 15 % participation by financial institutions or scheduled commercial banks, of which at least 10% has to come from the appraisers. In this case, 10% of the issue size has to be allotted to qualified institutional buyers.

In both cases, either the minimum post-issue face value capital of the company is at least Rs.100,000,000 (Rupees one hundred million) or there has to be a compulsory market-making for at least two (2) years from the date of listing of the shares. The market makers shall undertake to offer buy and sell quotes for a minimum depth of 300 shares. They have to ensure that the bid-ask spread for their quotes does not at any time exceed 10%. The inventory of the market makers on each of the stock exchanges, as on the date of allotment of securities shall be at least 5% of the proposed issue of the company.

In any case, there must not be an allotment pursuant to a public offering unless the prospective allottees are not less than one thousand (1000) in number.

3.4 Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (the "FEMA Regulations")

The FEMA Regulations prescribe the manner in which a foreign venture capital investor can make investments. A foreign venture capital investor, can through SEBI, apply to the RBI for permission to invest in an Indian venture capital undertaking, a venture capital fund or in a scheme floated by a venture capital fund. The consideration amount for investment can be paid out of inward remittances from abroad through normal banking channels. Subject to RBI approval, a foreign venture capital investor can maintain a foreign currency or rupee account with an authorized Indian bank. The funds held in such accounts can be used for investment purposes.

An Indian company has automatic approval to issue capital to a person resident outside India, provided, it is not engaged in any activity or the manufacture of items which are restricted. Further, the investment must be within the sectoral limits for foreign investments specified in the FEMA

regulations. Additionally, the company is required to comply with the provisions of the Industrial Policy as notified by the Secretariat for Industrial Assistance ("SIA") in the Ministry of Commerce and Industry.

Restricted businesses include domestic airlines, petroleum sector (except for private sector oil refining), investing in companies in Infrastructure and service sector, defence and strategic industries, atomic minerals, print media, broadcasting, postal services, courier services, establishment and operation of satellite, and tea sector. Approval of the Foreign Investment Promotion Board ("FIPB") or the SIA is required to invest in these areas or to exceed the specified sectoral caps. FIPB or SIA approval is also necessary for a domestic venture capital fund seeking funds from abroad.

Foreign direct investment is prohibited in retail trading, atomic energy, lottery business, gambling and betting, agriculture (excluding floriculture, horticulture, development of seeds, animal husbandry, pisiculture and cultivation of vegetables, mushrooms etc under controlled conditions and services related to agro and allied sectors) and plantations (other than tea plantations).

A foreign venture capital investor cannot purchase shares or convertible debentures of an Indian company engaged in the print media sector.

Further, a foreign venture capital is exempted from the approval requirement under Press Note No.1 (2005 Series) which stipulates that a foreign investor who already holds investments in India must obtain the FIPB's approval before investing in another entity engaged in the same field.

3.5 Income tax Act, 1961 (the "IT Act")

Venture capital funds registered with SEBI are entitled to several tax concessions. These funds are considered pass through entities and are exempt from tax. The salient provisions of the IT Act have been discussed below:

- The income of a venture capital fund, set up to raise funds for investment in a venture capital undertaking, is exempt from income tax. (Section 10(23FB) of the IT Act) The income of a venture capital fund will continue to be exempt, if the undertaking, in which its funds are invested, subsequent to the investment gets listed on a stock exchange. (Explanation 2 to section 10(23FB) of the IT Act)

However, tax will be payable by the shareholders or withholders of the fund.(Section 115U(1) of the IT Act)

- Venture capital funds are exempt from withholding tax in respect of income distributed to their investors. The provisions of the IT Act, regarding taxation on distributed profits (dividend), distributed income and deduction of tax at source do not apply to venture capital funds. (Section 115U(4) of the IT Act)

4. Enforcement

A party to a venture capital transaction relies on both contractual and statutory measures to obtain performance of obligations from the other party. The provisions of a share escrow agreement, which is commonly entered into in venture capital transactions, can be invoked to ensure performance of obligations. The parties may also enter into automatic share transfer arrangements.

Besides such contractual measures, the parties can also seek relief by bringing a suit for specific performance of the contract. Litigation must, however, be the last resort. The judicial process in India is lengthy and cumbersome. It can take anywhere between fifteen (15) to twenty (20) years for a suit to reach final hearing and disposal. In venture capital transactions, it is beneficial for the parties to settle their disputes amicably through alternate modes of dispute resolution such as negotiation, arbitration, etc., before indulging in litigation.

The CLB, which will soon be replaced by the NCLT, is empowered to adjudicate in respect of certain matters falling within the Cos Act. The decision of the CLB on any question of fact is final. If the CLB order involves a question of law, an appeal can be filed in the High Court. The CLB and the High Courts are empowered to grant interim reliefs. Pending an interim relief, the courts may provide ad-interim reliefs to the aggrieved party. Interim and ad-interim reliefs are significant only if there is an enforceable security. There are several instances, where a court has ordered the board of directors to comply with company law requirements. The Kerala High Court set aside a deceitful allotment of shares to the managing director of a company.[10] In this case, shares were issued to the managing director without notice to the initial investor in the company, who was earlier allotted 70% of the shares in that company.

[10] *P.K. Prathapan v. Dale and Carrington Investments (P.) Ltd.* [(2002) 38 SCL 827].

5. Conclusion

VCs have a significant role to play in the development of the Indian economy. Currently, there are a variety of issues that need to be immediately addressed. One of the major drawbacks of the existing regulations is that they do not permit venture capital investment in listed companies. Therefore, venture capital investors, registered with SEBI, cannot apply their resources to revive poorly performing units, of which there are many in India.. The restriction on investments in certain sectors and the regulatory complexities are putting off some offshore investors. More liberalization is required on this count, and the right set of reforms will bring better prospects for the economy.