

# Deal Terms & Why do you need a good lawyer

IVCJ Executive Training Programme  
Private Equity & Venture Capital at Fund and Company Levels

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India Juris

International Law Firm

## Structuring the deal – legal issues

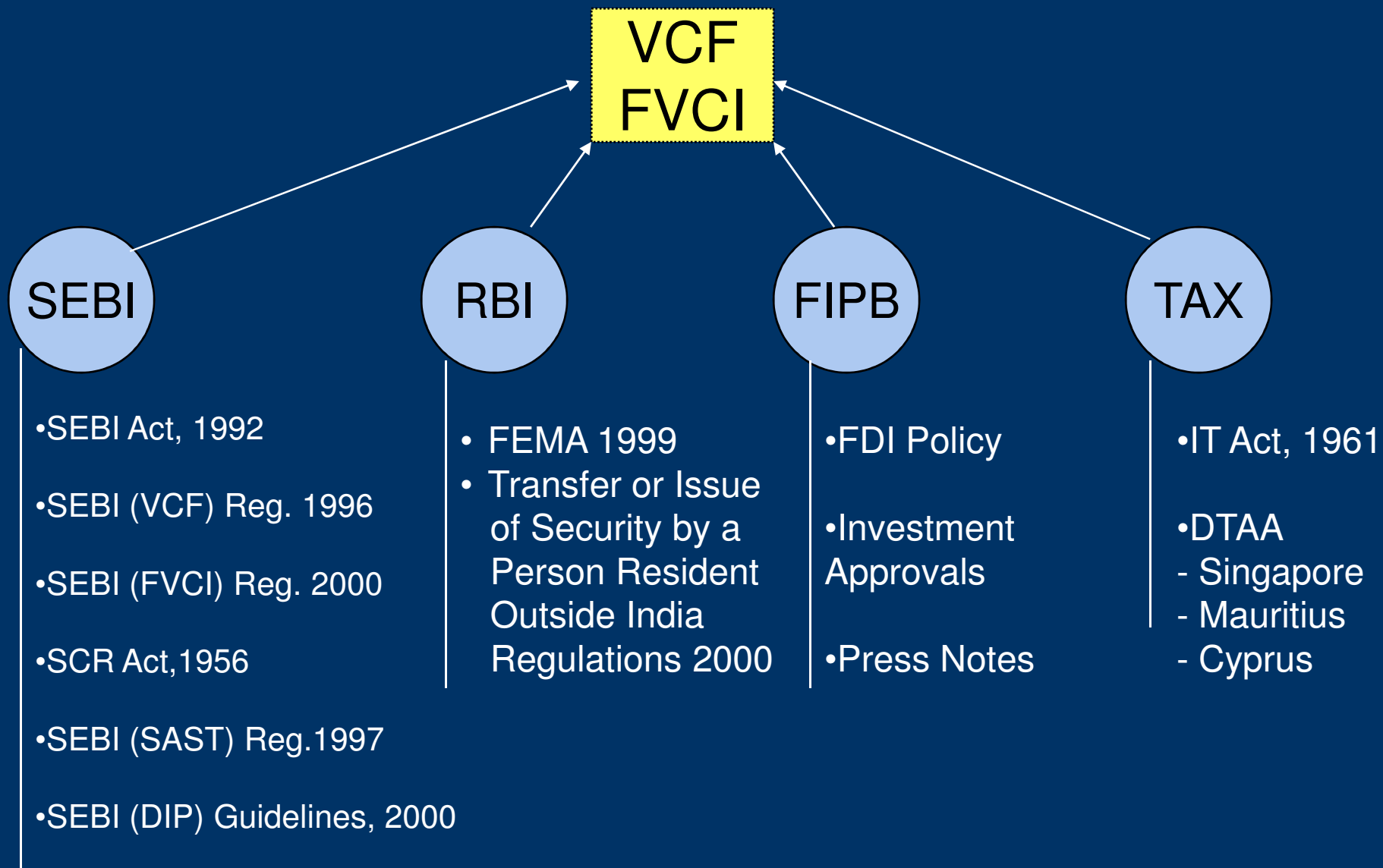
What is deal  
structuring  
?



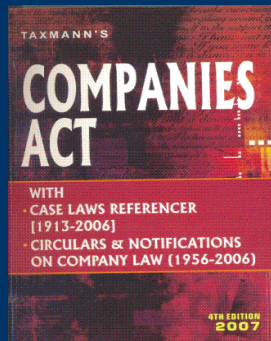
From where, through what vehicle, at what time, what amount, in which company, through what instruments, investment is made in most tax efficient manner, so that entry and exit are very easy & flexible

Ideally win-win situation for PE / VC & Entrepreneur both

# Deal Terms & Why do you need a good lawyer



## Commercial Laws

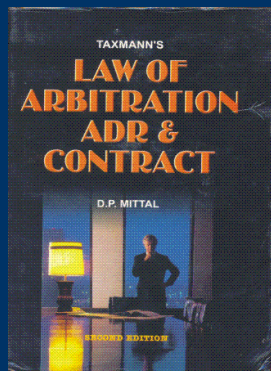


Companies Act 1956

1

Indian Trust Act 1882

3



Indian Contract Act 1872

2

LLP Bill 2006

4



## Structuring the deal – legal issues

1. Type of Shares [section 80, 80A, 85]
  - a. Preference Shares
    - preferential right to fixed amount or rate
    - preferential right on repayment on winding up
    - redeemable / irredeemable
    - convertible / non-convertible
    - cumulative / non-cumulative
  - a. Equity Shares

## Structuring the deal – legal issues

### 2. Voting Rights

[section 87]

#### a. Equity Shareholder

- has right to vote on every resolution placed before the company

#### b. Preference Shareholder

- has right to vote only on resolutions which directly affect their rights
- cumulative / non cumulative can vote on all resolutions if dividend are in arrear for not less than two years

## Structuring the deal – legal issues

### 3. Dividend Rights

PE would generally ask for preference shares with cumulative dividend rights with usually fixed at a % of the subscription price

The company may also be prevented from paying dividend to any other equity shareholder till dividend is paid to preferred shareholder [PE]

## Structuring the deal – legal issues

### 4. Board Representation

PE / VC may require its representation on Board for monitoring and control

### 5. ESOPS

Employee Stock Option Plans – issue of ESOPS to employees / directors will result in dilution of shareholding of PE / VC

Accordingly it may ask for fully diluted valuation



## Structuring the deal – legal issues

### 6. Intellectual Property

Should be included in the valuation of the company

### 7. Non Disclosure / Confidentiality

### 8. Non Compete

PE / VC may require key person or techno persons of the company to enter non-compete Agreement with the Company.

## Structuring the deal – legal issues

### 9. Anti Dilution - Full Ratchet

- To protect the value of PE / VC stake if new shares are issued at lower price
- New shares issued to PE / VC at no or nominal cost to offset the dilative effect of issue of cheaper shares
- Issue of additional shares to PE to maintain its ownership at same level
- Several variations of formula to provide different degree of protection

## Structuring the deal – legal issues

### 10. Drag Along

This provision might create obligation on all shareholders of the company to sell their shares to a potential purchaser, if certain % of the shareholders vote to sell to the purchaser

### 11. Pre-emptive rights

If one shareholder wishes to dispose of shares that are subject to a pre-emptive right, it must first offer to existing shareholders before selling to third party

## Structuring the deal – legal issues

### 12. Exits

- IPO
- Strategic sale

### 13. Dispute Resolution

- Litigation / Arbitration
- India or abroad
- Governing laws & procedure

## Protecting the Entrepreneur

### ➤ Drag Along Clause

When PE decides to sell its stake to third party, the entrepreneur is dragged along / forced to sell his stake

The clause may not be stated upfront, but can be cleverly worded in the document.

### ➤ Material Adverse effect clause

PE may walk out if market for the entrepreneur turns unfavorable. Material adverse effect must be clearly worded

## Protecting the Entrepreneur

### ➤ Information Rights

PE may demand information rights, which is mainly promise from entrepreneur to provide unaudited quarterly financial statements & audited annual statements

### ➤ Jurisdiction

Outside India may be costly and inconvenient to entrepreneur

## Control

Usually, projects financed by PE / VC are characterized by a high level of economic and technological uncertainty. Difficulties to exit the investment, information asymmetry, heterogeneous expectations, and differences in the level of risk aversion complicate the matter further.

HOW to control the risk and at the same time provide entrepreneurs with enough incentives to work hard



## Control

### Control mechanisms

- Use of convertible securities / preference shares
  - o widely used in most of the PE / VC deals
  - o reduce the problem of excessive entrepreneurial risk



## Control

### Control mechanisms

- Staging of capital infusions
  - Staging the commitment of capital is one of the best ways to allocate risks between entrepreneurs and PE / VC in the manner beneficial to both parties
  - Best guarantee for a VC / PE is entrepreneurs' substantial share after entrance

## Control

### Control mechanisms

- Syndication of investments

Syndication relationships serve as a mechanism for spreading deal-related information to trusted partners

Syndication also means risk sharing via portfolio diversification

## Financial Covenants “FC”

FC may be part of the agreement, FC are the promises by the company to adhere to certain limits. For example, not to allow certain balance sheet items or ratios to fall below or go over an agreed upon limit.

PE / VC generally does not want to get involved in day to day financial activities, one reason being to avoid any liability

FC protects PE, by acting as an early warning system before something goes wrong. This allows PE to step in before default occurs and take corrective measures

## Financial Covenants “FC”

### Examples

**Debt Equity Ratio** = Debt / Equity

**Net Income**

**Interest Cover** = EBITDA / Finance charges

**Leverage** = Total Net Debt on last day of relevant period / EBITDA for the relevant period

**Debt Service Cover Ratio (DSCR)** = Net revenue during relevant period / Sum of financing costs due during same relevant period

## Representations & Warranties “R&W”

To be provided by the Key founders, management and the company. It generally covers

- Legal existence of the company
- Financial statements
- Assets
- Ownership ex. IPRs
- Liabilities
- Material contracts
- Contacts with key personnel's

Company to reimburse the PE for diminution in the share value attributable to the R&W being inaccurate

## Service Contracts

PE may require Restrictive Agreement with Key Persons

- Section 27 – Contract Act 1872

Any agreement in restraint of trade and profession is void

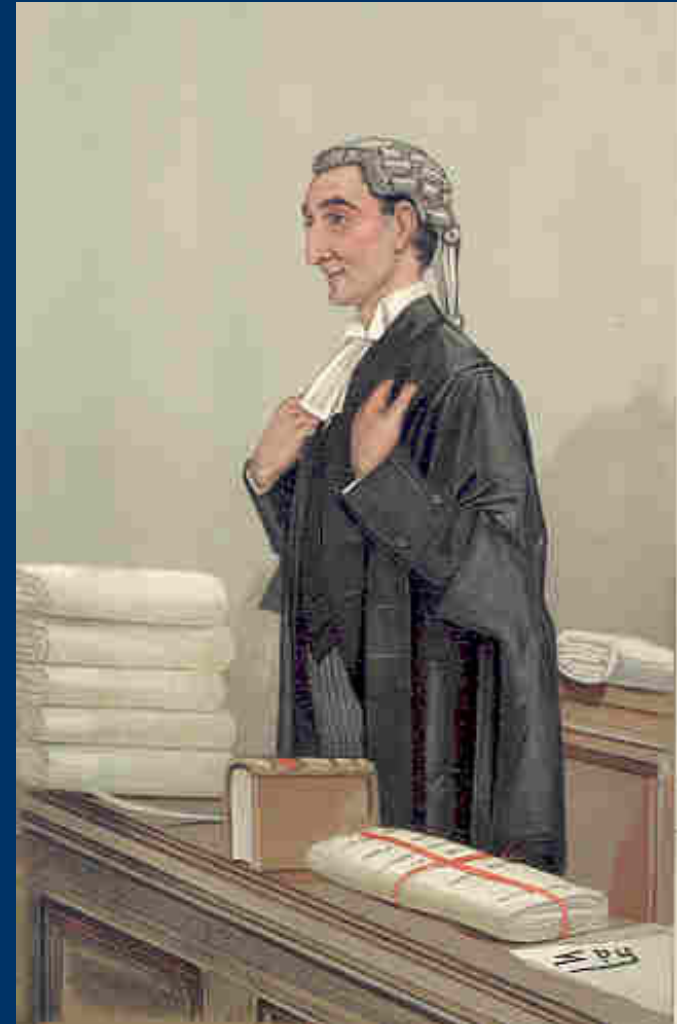
Partial restriction allowed

## Shareholders Agreement

Memorandum & Articles of Association - prevails over Shareholder Agreements – MoA & AoA should be altered accordingly

This Agreement will provide full details of arrangement between the PE & Entrepreneur and includes all the provisions as mentioned earlier

**By now it must  
be clear why  
you need a  
good lawyer  
for successful  
deal**





*THANK YOU*

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