VENTURE INTELLIGENCE
Private Company Financials, Transactions, Valuations

Handbook on Venture Capital

An Entrepreneur's guide to Early Stage Funding

July 2014

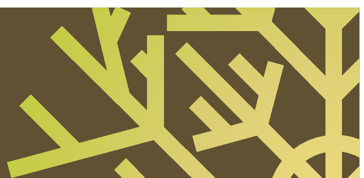

Table of Contents

Venture Capital Investor landscape in India	3
An Interview with Sarath Naru, Managing Partner, Ventureast.	5
Venture Debt: A Catalyst for Growth	7
Entrepreneur Interview: Gaurav Jain of Mast Kalandar	9
Negotiating Term Sheets - Legal Issues	10
Venture Capital Investor Directory	13
- Accelerators	16
- Incubators	18
- Angel Investors	25
- Seed Funds	26
- VC Firms	29
- SME Investors	34
- Social VC / Impact Investors	36

Negotiating term sheets - Legal Issues

Overview of main provisions in Term Sheets

'Term sheet,' 'non-binding term sheet,' 'indicative term sheet,' 'Letter of Intent,' 'Head of Terms,' 'Memorandum of Understanding,' 'Non-binding MOU' are commonly heard terms in the private equity / venture capital world. This article will look at commonly encountered issues in negotiating, and the issue of the enforceability of, these documents in the Indian context.

Simply put, a "Term Sheet", by whatever name called, and whether a simple 2-pager, or a detailed tome, is a document that sets out key financial, protective and governance terms of a proposed investment by a VC or a PE fund in a company looking for investment.[1] What they all usually have in common is the understanding that they are not binding until the execution of 'definitive documentation.[2] Typically, the financial provisions covered in a Term Sheet are the proposed investment amount, valuation of the company, type of investment instrument, and a timeline for the investor's exit, together with indicative exit mechanisms.[3] Governance terms and protective provisions include the composition of the board of directors, a lock-in over the founders' shares, and sometimes, detailed provisions governing share transfers. Protective provisions will seek to safeguard the fund's investment in several ways, for example, the right to receive detailed information about the company's financial health (including management information system reports and unaudited monthly financial statements). The right to veto certain actions, and anti-dilution rights in future financing rounds, are also commonly seen.

Financial provisions

What instrument? Once the parties have agreed on the valuation of the company, the next question is as to what kind of investment instrument is desired. Available options are equity shares, preference shares, and convertible instruments.[4] Note that in case of investments by non-resident funds, all shares must be fully paid-up[5], and the price per share must be above the 'fair value' arrived at in accordance with prescribed methods. Several factors influence the fund's choice of instrument. The principal one is how the fund envisions its role in the company. Funds which want to have a hands-on, operational role in the day-to-day affairs of the company may choose large or controlling stakes of above 50% of the equity shareholding. Funds for which the investment is a purely financial one may choose convertible instruments.

1. For a detailed analysis of private equity fund formation and transactions in India, please see http://www.samvadpartners.com/wp-content/uploads/2013/06/Getting-The-Deal-Through-India-Private-Equity-2012-Fund-Formation-Chapter.pdf. http://www.samvadpartners.com/wp-content/uploads/2013/06/Getting-The-Deal-Through-India-Private-Equity-2012-Transactions-Chapter.pdf
2. Typically, a share subscription or purchase agreement and a shareholders agreement.
3. Including initial public offers ("**IPO**"), strategic sale, 'put option,' 'call option' among others. The 'Liquidation Preference' clause is also a significant one.
4. Such as convertible debentures or preference shares. Also, convertible instruments must be fully and mandatorily convertible in order to be reckoned as equity. Partly convertible or non-convertible instruments would be reckoned as debt and subject to the more onerous rules applicable to external commercial borrowings.
5. Partly paid instruments are not allowed for FDI, except with prior approval of the Government.

The fact that convertible debentures, while in the unconverted state, rank as debt; and in that form, rank higher than the holders of equity shares in the queue of persons eligible to receive distributions (in the event of the company being wound up), are factors that funds take into account.

What rights can the instrument have? Note that shares with differential voting rights ("**DVR Shares**") cannot be freely issued by companies, without complying with certain conditions.[6] In this context, the 'Liquidation Preference' clause assumes significance. In jurisdictions like the United States, where (comparative to India) companies can be wound up or liquidated relatively quickly, the term 'liquidation preference' is used to imply that in the event the company is liquidated or sold, i.e., an exit event is created, the fund would first get its returns (1x, 2x, etc.) before the founders get their share. However, the use of this term in the Indian context gives rise to some confusion (since the word 'liquidation' suggests dissolution of the company, the process for which is prescribed under the Indian company law). The Indian company law also prescribes the manner in which available moneys must be paid out[7] , and hence, any contractually agreed clauses on the manner in which moneys must be distributed upon winding-up may not be given effect to by courts. The better expression is, therefore, a 'distribution preference' arising upon the occurrence of a 'liquidity' event, namely, a transaction that realizes the 'value' of the company, typically, in cash (although a share or stock deal is not ruled out, except that achieving it is a regulatory challenge). Note however that there is no contractual restriction on agreeing as to how moneys must be distributed in case of other exit events such as sale to a third party (who may be a strategic or financial investor), as long as applicable exchange control and taxation laws are complied with.

To avoid confusion in the Indian context, it is important to perhaps separate the 'Liquidation preference' clause into two distinct strands – one, what happens in case of winding up under the Indian company law, and two, what happens in case of an exit or 'liquidity' event. Unfortunately, it is not unusual to see the terms 'liquidity' and 'liquidation' being (incorrectly) used interchangeably.

Exit provisions. Commonly used exit provisions include initial public offering, strategic sale, buy-back, and put / call options. Put / call options have received some welcome regulatory sanction recently. Over the last few years, the 'put option' and 'call option' have been in the eye of a regulatory storm in India. This is because the Reserve Bank of India ("**RBI**") considered these options as granting foreign investors guaranteed returns, giving the investment instrument debt-like features, as opposed to equity. The Securities Exchange Board of India ("**SEBI**") considered that all options must only be exchange-traded and cannot be off-exchange, contractually agreed between parties.[8] The RBI has, in January 2014, allowed issuance of equity shares and compulsorily and mandatorily convertible preference shares and debentures containing an optionality clause, but without any option / right to exit at an assured price, to a person resident outside India. These

Negotiating term sheets - Legal Issues

instruments are viewed as eligible instruments to be issued to a person resident outside India by an Indian company, subject to certain terms and conditions.

Governance Terms

Board and Shareholder meetings. Funds would want a say in the way the company is run, on certain important items, at least, and will typically nominate at least 1 director to the company's board, coupled with a list of items on which the board cannot proceed unless such nominee director has consented. This list is typically replicated at the shareholder level as well, such that no resolution can be passed by the shareholders in general meeting on the specified list of matters, unless the fund, as a shareholder has consented (whether at the shareholders' meeting, through its authorized representative, or through a separate written consent).[9] While most funds seek to nominate a director(s) on the company's board, there has been a rise in the trend where certain funds prefer to appoint an "observer" on the company's board instead of a director.

Restrictions on Share Transfers. The ability to restrict the transfer of shares in private companies is important from the investors' point of view.[10] Typically, such investors would want to ensure that the founders / promoters of their investee company cannot unilaterally decide to jump ship in the event the company's business is floundering – therefore, elaborate provisions governing the transfer of shares is typically included in transaction documents and replicated in the articles of association of the company. These include rights of "tag-along," "drag-along," "come along", rights of first offer and rights of first refusal. While these rights are now fairly common in the industry, their enforceability in court is yet to be tested.[11]

Enforceability of Term Sheets in India

There have not been significant judicial pronouncements on the question of enforceability of a venture capital term sheet.[12] To summarise, term sheets are preliminary agreements, evidencing an intention of the parties to enter into a contract at a future date. Such 'agreements to agree' are not enforceable under both English and Indian law, although, there may be exceptions depending on the facts and circumstance of each case, the conduct and the intention (whether express or implied) of the parties to create legal relations. Whether or not a term sheet is binding on the parties depends on the provisions contained therein. Therefore, the parties must employ a clear and unambiguous language to avoid disputes. Certain clauses like Exclusivity, Confidentiality and 'No-Shop,' and the related Dispute Resolution provisions, must be expressly stated to be valid and binding, independently of whether or not the deal goes ahead with the execution of definitive documentation. Importantly, clauses dealing with costs or fees, and who is to bear them, whether or not the deal goes through, must also be clearly indicated to be binding, so as to avoid unpleasant shocks later. The concept of 'break-fees' and its payment, is another clause, that must be made so binding irrespective of deal closure.

6. For example, one of the key conditions is that the company have distributable profits in the 3 financial years prior to the year in which DVR Shares are to be issued.
7. First, and paripassu,to secured creditors and workmen; thereafter to satisfy all other debts; and only finally to shareholders (preference and equity, in that order).
8. For a detailed article on the subject, see http://www.siac.org.sg/index.php?Option=com_content&View=article&id=406:enforceability-of-put-and-call-options -in-india-in-the-current- regulatory-environment&catid=56:articles&Itemid=171
9. These rights carry greater weight in private companies, while in public and public listed companies, the legal implications of these kinds of rights is very much a grey area. When the question of whether these 'affirmative rights' or 'veto rights' amount to the fund acquiring 'control' over the investee company for the purpose of the takeover regulations came up before the SEBI, SEBI ruled in the affirmative. The Securities Appellate Tribunal ("**SAT**") reversed SEBI's order. The matter went up before the Supreme Court, but was unfortunately settled before the Supreme Court could pass an order on the merits. The Supreme Court did however expressly state that the SAT's ruling was not to be treated as precedent. There is a likelihood that in the future a regulator or court could take the view that funds enjoy 'control' over their investee companies, with attendant legal implications.
10. Shares or debentures or other interest of any member in a company are movable property "transferable in the manner provided by the articles of the Company." (S. 44, Indian Companies Act, 2013). One of the important differences between private and public companies in India is that a private company must by definition restrict the right to transfer its shares. For public unlisted and listed companies, unfettered transferability of shares is key.
11. This is important when one recalls that foreign investment rules are layered upon the Indian company law. So, while the above rights may fall within the ambit of the Indian company law's provided right to private companies to restrict the transferability of shares, FEMA regulations still have to be considered. Therefore, a foreign investor may not be able to enforce its drag right in FEMA-regulated sectors, unless the pricing guidelines are complied with.
12. Although the question has come up several times before Indian courts in the commercial contracts context.

Introduction and overview

Samvad: Partners is a partner-led, solution-oriented law firm, formed by the merger of Narasappa, Doraswamy & Raja ("**NDR**") and V Chambers of Law. The Firm is committed to providing smart and quality legal advice to our clients; maintaining the highest levels of professional integrity; and nurturing our lawyers in a work environment that motivates them to achieve and maintain the highest standards.

The Partners of the Firm – Mr. Harish Narasappa, Ms. Neela Badami, Ms. Nivedita Nivargi, Ms. Poornima Hatti, Mr. Rohan K. George, Mr. Siddharth Raja and Ms. Vineetha M. G. – are leaders in their respective fields of practice. The majority of our Partners have a rich mix of domestic and international experience, having worked in several legal and financial capitals around the world, including London, Hong Kong, Singapore, Mumbai, New Delhi and the Hague. Our lawyers are truly international, with several being admitted to practice law in India, England & Wales and New York, bringing with them a deep and diverse international perspective.

With offices in Bangalore, Chennai, Mumbai and New Delhi – the Firm's partners and the legacy firm NDR have regularly received the highest accolades and ranking from our peers, including recognition in **Chambers & Partners** and **Legal500**, over the past few years.

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