**IBA Guide on Shareholders’ Agreements**

**India**

**N. Raja Sujith**

**Partner, Head - South India**

**Majmudar & Partners, International Lawyers**

**104, Prestige Meridian-I, No 29, M.G. road Bangalore 560 001, INDIA | T: +91 80 4147-0000 | F: +91 80 4147-0010**

1. **Are shareholders’ agreements frequent in India?**

Shareholders’ agreements are used quite frequently by medium and large Indian companies.

1. **What formalities must shareholders’ agreements comply with in India?**

Shareholders’ agreements are not mandatory under Indian laws. Shareholders’ agreements are binding only on the parties to the shareholders’ agreement and as it is a contractual arrangement between the parties.

1. **Can shareholders’ agreements be brought to bear against third parties such as purchasers of shares or successors?**

Under Indian laws shareholders’ agreements are not enforceable on third parties. It only binds the parties to the shareholders’ agreement. However, if the shareholders agreements are to be enforced against third parties, company regulated issues (as in certain case non-company regulated issues) should be included in the shareholders’ agreement must be included in the byelaws of the company. Byelaws of the company are public documents and hence it is the duty of any third party to review the byelaws before entering into any transaction with the shareholders of the company.

1. **Can a shareholders’ agreement regulate non-company contents?**

The Indian law does not prohibit regulating non-company contents in the shareholders’ agreements. Non-company contents like management rights, licensing intellectual property etc. are commonly included in the shareholders’ agreements.

1. **Are there limits on the term of shareholders’ agreements under the law of India?**

There are no limits specified under the Indian laws to restrict the term of shareholders’ agreements. The term of the shareholders’ agreements is at the discretion of the shareholders entering in to the shareholders’ agreements.

1. **Are shareholders’ agreements related to actions by directors valid in India?**

Shareholders’ agreements related to actions by directors are not valid in India. Courts in India came down heavily on clauses under shareholders agreements which oblige a director of a company to undertake an obligation to benefit certain shareholders by compromising his fiduciary duties.

Directors are fiduciaries of the company and the shareholders. They cannot abdicate their independent judgment by entering in to pooling agreements*.*

1. **Does the law of India permit restrictions on transfer of shares?**

In India, the companies limited by shares are of two types, i.e., private companies and public companies.

Private companies are closely held companies and hence have the right to regulate transfer of shares by the shareholders as per its byelaws. However, in case of public companies, the shares are freely transferable.

1. **What mechanisms does the law of India permit for regulating share transfers?**

The most commonly used mechanisms to regulate transfer for shares are:

(a) ***Right of first refusal***. This is an agreement between the existing shareholders whereby the shareholder wishing to sell to a third party must first offer the shares to the holder of the first refusal right. If the holders of the right of first refusal do not buy the shares, the shareholder normally can freely sell to a third party. This is the basic structure, but its regulation and mechanisms can be diverse and highly complex.

(b) ***Right of first offer***. This is a variation of the right of first refusal in which a fixed price is agreed to from the outset. The shareholder wishing to sell shall first offer the shares to the holder of the right of first offer holder at the fixed price. If the holder of the right does not purchase the shares, the shareholder wishing to sell is free to sell it to a third party.

(c) ***Drag-along and Tag-along Rights.*** Drag**-**along rightis an agreement between the shareholder, where the shareholder wishing to sell his shares to a third party has the right to drag all the other shareholders and make complete exit from the company. Tag-along right is the opposite the other shareholders have a right to tag along with the shareholder wishing to sell his shares to a third party.

(d) ***Buy-back rights***. These give the company the right to redeem the shares of a certain shareholder in specific circumstances, such as withdrawal or death of the shareholder.

(e) ***Call option***. Call option gives its holder the right to buy a specified number of shares of the underlying stock at a predetermined price (strike price) between the date of purchase and the options expiration date.

(f) ***Put Option***. Put option gives its holder the right to sell a specified number of shares of the underlying common stock at a predetermined price (strike price) on or before the expiration date of the contract.

1. **In India do bylaws tend to be tailor-drafted, or do they tend to use standard formats?**

Bylaws are mostly drafted using standard formats. However, depending on need of the company and its business, bylaws are also tailor made. Increasingly, the byelaws of a lot of companies are not tailor-made.

1. **What are the motives in India for executing shareholders’ agreements?**

Shareholders agreements lay down clearly defined rights and obligations between of the parties, i.e., (a) appointment of directors and quorum requirements; (b) determining the matters requiring special resolution or providing veto rights to certain shareholders (more so in case of private equity and venture capital partners); (c) financing the requirements of the company; (iv) restrictions on right to transfer shares freely; (v) defining the obligation of each of the shareholder towards the company.

This is a contractual remedy available to an aggrieved shareholder in the event of any breach of any covenant or representation by the other shareholder. This contractual remedy is available to a shareholder in addition to the statutory rights provided under the Indian Companies Act, 2013(“**Act**”) and rules made there under, if the byelaws have been amended to incorporate the relevant provisions of the shareholders’ agreements.

1. **What contents tend to be included in shareholders’ agreements in India?**

Shareholders agreements are more flexible and companies in India include various company and non-company regulated matters. However, companies should include the company regulated matters in the byelaws of the company to receive protection under the Act and rules made there under, as the shareholders agreement is just a contractual arrangement between the parties and will not be regulated by the Act.

Hence, most companies amend their byelaws after signing the shareholders agreement to obtain benefits under the Act along with the contractual remedy available directly under the shareholders agreement.

1. **What determines the content included in shareholders’ agreements in India?**

A shareholders agreement typically grants rights to those shareholders who are party to the agreement that are above and beyond the rights that are inherent in the shares that they own, and is intended to ensure that those shareholders obtain the benefits of the additional rights that they bargained for when making their investments.

For example, shareholders agreements may allocate among certain shareholders rights to designate the individuals who will serve on the company’s board of directors, grant certain shareholders special voting rights, ensure that certain shareholders have preemptive rights if the company issues additional equity securities, and/or provide rights to limit or participate in transfers of shares by other shareholders, among other things. Although “freedom of contract” is the legal principle that governs many provisions contained in typical shareholders’ agreements, there are numerous legal considerations that affect their enforceability and effectiveness.

1. **What are the most common types of clauses in shareholders’ agreements in India?**

The shareholder’s agreements provide for matters such as restrictions on transfer of shares (right of first refusal, right of first offer), forced transfers of shares (tag-along rights, drag-along rights), nomination of directors for representation on boards, quorum requirements and veto or supermajority rights available to certain shareholders at board level or shareholder level.

1. **What mechanisms does the law of India permit to ensure participation of minorities on the board of directors and its control?**

There are no specific provisions under Indian laws to ensure participation of minorities on the board of directors of a company. Also, Indian laws do not provide for provisions ensuring minority control over board of directors. However, the minority shareholders can be given right to nominate directors on the board of directors by contractual arrangement between the shareholders.

1. **Is it possible in India to ensure minority shareholder control by means of a shareholders’ agreement?**

Under a shareholders’ agreement minority shareholders can be given power to appoint directors on the board of directors of a company. However, that does not in any way mean that the minority shareholder has control over the company. The Act along with recent judicial decisions interpret the term ‘control’ to mean having voting power, or control of or participation in business decisions rather than a share in the capital of the company. The test of ‘control’ is satisfied when a shareholder has the ability to control and decide the management decisions of the company.

1. **What are the usual valuation mechanisms in connection with rights of first refusal or share transfer regulations?**

Typically, there are three modes of valuation for shares prevalent in India i.e., (i) P/E ratio method (ii) The DCF method and (iii) Price to Book Value Method (P/BV).

The price to earnings ratio or commonly referred to as the P/E ratio is calculated by dividing the market price of a stock by EPS (earnings per share). EPS in turn is calculated by dividing the net profit of the company by the number of shares outstanding.

The DCF method of valuation is used to estimate the attractiveness of an investment opportunity. DCF analysis use future free cash flow projections and discounts them (most often using the weighted average cost of capital) to arrive at a present value, which is used to evaluate the potential for investment.

The P/BV valuation method is another commonly used to valuation method. P/BV is calculated by dividing the market price of a share with its book value per share. The book value of a company is equal to the shareholder’s equity (share capital plus reserves and surplus). It can also be calculated by dividing net assets (Total assets - total liabilities) by total number of equity shares.

The foreign exchange laws in India do not mandate any specific method for valuation of unlisted shares. However, the law requires that the unlisted shares should be valued on any internationally accepted pricing methodology on an arm’s length basis.

As per the foreign exchange laws in India valuation of shares of a listed Indian company whose shares are being transferred from a resident to non- resident shall not be less than the price of shares for a preferential allotment computed in accordance with the Securities Exchange Board of India (“SEBI”) Guidelines, i.e., SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (“ICDR Regulations”). In accordance with the SEBI ICDR Guidelines, the price for preferential allotment (where shares are listed for more than six (6) months) shall be not less than the higher of the following:

(a) the average of the weekly high and low of the volume weighted average price of the related equity shares quoted on the recognised stock exchange during the 6 (six) months preceding the relevant date; or

(b) the average of the weekly high and low of volume weighted average prices of the related equity shares quoted on a recognised stock exchange during the 2 (two) weeks preceding the relevant date.

1. **Is it admissible for a shareholders’ agreement clause to refer dispute resolution to the courts other than those of India and/or under a law other than that of India?**

If there are one or more non-resident parties to the shareholders’ agreements, any law applicable to the parties can be included for resolving disputes. However, if any judgment is passed against an Indian party in a foreign court, and for such judgment to be enforced in India, a fresh suit on the judgment should be filed in India, if such foreign country does not have a reciprocity arrangement with India.

1. **Is it admissible for a shareholders’ agreement to include an arbitration clause with seat outside India and/or under a law other than that of India?**

The parties to the shareholders agreement are free to include an arbitration clause with seat outside India and/or under a law other that of India as long as one of the party to the shareholders is a non-resident. However, the parties should specifically include a clause excluding Part 1 of the Indian arbitration Act, 1996 to avoid the interference from courts as per provisions of the Indian Arbitration Act, 1996 being applicable to it.