IBA Guide on Shareholders' Agreements

India

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1. Are shareholders' agreements frequent in India?

In India, having a shareholders' agreement to govern the relationship *inter se* the shareholders of an Indian company is commonplace in case of private equity (PE), venture capital (VC) and strategic M&A transactions, and in medium and large Indian companies where the stakeholders include institutional investors and corporate entities. However, it is not very common among promoter/family-run private/closely held unlisted public companies.

2. What formalities must shareholders' agreements comply with in India?

Shareholders' agreements are not mandatory under Indian law. Having a shareholders' agreement in place is considered more from a good governance and management of the corporate entity standpoint. A shareholders' agreement is like any other commercial contract between the interested parties (ie, shareholders of a company). Therefore, there are no specific formalities per se for the shareholders' agreement to comply with. Like any other agreement executed in India, a shareholders' agreement has to be duly stamped under the applicable stamp laws in India prior to execution. Though not strictly required, it would be advisable for the relevant company to also be a party to the shareholders' agreement so that the company is directly bound by its terms. The provisions of the shareholders' agreement should be incorporated in the articles of association of the corporate entity to bind the corporate entity and its shareholders *inter se*.

3. Can shareholders' agreements be brought to bear against third parties such as purchasers of shares or successors?

Under Indian laws, an agreement is not enforceable against third parties who are non-signatories to an agreement. It only binds the parties/signatories to the relevant agreement. Accordingly, a shareholders' agreement will not bind a third-party non-

signatory. However, to make third parties bound by the provisions of a shareholders' agreement, the provisions of the agreement are incorporated in the articles of association (by-laws) of the company, which is a document accessible by the public at large at the corporate registry.

Indian law recognises the 'Doctrine of Constructive Notice', which in the context of the Indian Companies Act means that any person dealing with a company is deemed (or 'construed') to have knowledge of the company's articles of association and memorandum of association. The Indian company and other non-signatory shareholders will not be bound by a shareholders' agreement unless its terms are reflected in the articles of association of the company. The articles of association of an Indian company refers to a contract between the Indian company and its shareholders *inter se*. With respect to third parties such as purchasers of shares or successors, a shareholders' agreement will not be binding on them by default, unless such a provision is contained in the shareholders' agreement and the articles of association of the Indian company.

Typically, in India, shareholders' agreements provide for a provision of a 'deed of adherence', which is to be executed by incoming shareholders (whether as purchasers pursuant to transfer or successors pursuant to transmission/inheritance of shares). Such a 'deed of adherence' provides that the incoming/new shareholder shall substitute the outgoing shareholders and shall be bound by all the terms of the shareholders' agreement applicable to such outgoing shareholders.

4. Can a shareholders' agreement regulate non-company contents?

A shareholders' agreement provides for matters pertaining to the company, its management and operations and the *inter se* rights and obligations of the shareholders vis-à-vis the company. It would be unusual for a shareholders' agreement to provide for matters that are not related to the company. Having said that, as mentioned above, a shareholders' agreement is a commercial contract and the parties are free to negotiate and agree on its contents (including non-company contents) provided that the shareholders' agreement is not in breach of the provisions of the Indian Contract Act.

5. Are there limits on the term of shareholders' agreements under the law of India?

There are no limits specified on the term of shareholders' agreements under Indian laws. The term of shareholders' agreements is at the discretion of the shareholders of the Indian company entering into shareholders' agreements. Usually a shareholders' agreement gets terminated with respect to a shareholder once such a shareholder ceases to be shareholder in the company for which the shareholders' agreement is executed. Additionally, a shareholders' agreement may also provide for a 'fall-away' provision where certain identified rights of a shareholder 'fall away' (ie, cease to be effective) in the event that the shareholding of a particular shareholder falls below a certain pre-agreed percentage.

6. Are shareholders' agreements related to actions by directors valid in India?

The Indian Companies Act specifically provides that it is a duty of a directors to act as fiduciaries of the company and shareholders. Accordingly, a director cannot compromise their fiduciary status and act in favour of a particular shareholder. In relation to shareholders' agreement-related action by directors, the Indian courts have held that a pooling agreement (like a shareholders' agreement) cannot be used to supersede the statutory rights given to the board of directors to manage the company. The duties of a director are owed to a company for the benefit of its members as a whole, and not to the members individually, even if such a member is the controlling shareholder of the company.

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

In India, the most commonly used forms of limited liability companies are private limited companies and public limited companies. By its very nature, the shares of a private company are not freely transferable, and the transfer of shares by the shareholders of a private company are restricted as per the articles of association of the company. However, shares of a public company, by their nature, are freely transferable. In both cases, a contractual fetter/restriction on the transfer of shares is enforceable under Indian law.

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

Commonly used mechanisms in India to regulate transfer for shares are:

Non disposal undertaking/lock-in restrictions

It is common in PE/VC transactions and in certain strategic M&A transactions to provide for non-disposal/lock-in restrictions on the shares held by the promoters of the Indian company from transferring/disposing off their shareholding in the company to protect the interests of PE/VC investors and strategic investors.

Right of first refusal

This is an agreement between existing shareholders whereby the shareholder wishing to sell to a third party on the basis of an offer received must first offer the shares to the holder of the right of first refusal (ie, the other shareholder(s)). If the holder of the right of first refusal does not buy the shares, the shareholder can sell to a third party on the basis of the offer received from such a third party.

Right of first offer

This is an agreement between the existing shareholders whereby the shareholder wishing to sell, shall first offer the shares to the holder of the right of first offer holder (ie, the other shareholder(s)) and the shareholders shall discuss and agree on the purchase and sale terms, including the price. If the holder of the right does not exercise its right to purchase the shares, then the selling shareholder is free to sell it to a third party on the same or better terms.

Drag-along and tag-along rights

A drag-along right is an agreement between the shareholders, where a shareholder wishing to sell their shares to a third party has the right to drag all the other shareholders and make a complete exit from the company. A tag-along right is where the other shareholders have the right to tag along with the shareholder (ie, sell their shares along with the selling shareholders) wishing to sell their shares to a third party. Generally, tag along is an additional right granted to the holders of the right of first refusal/right of first offer in case the selling shareholder decides to sell its shares to the third party.

Buy-back rights

Generally, in PE/VC transactions and certain strategic M&A transactions, the investors/third-party shareholders can cause the promoters/company to buy back their shares to provide them with an exit.

Call option

A call option gives its holder the right to buy certain shares of the Indian company from other shareholder(s) at a pre-determined price/pricing mechanism at a future date or on the happening of an event. For instance, a call option is generally mentioned in the shareholders' agreement as a consequence of an event of default by a shareholder where the shares of a defaulting shareholder are purchased by the non-defaulting shareholder at a discount.

Put option

A put option gives its holder the right to sell certain shares of the Indian company to other shareholder(s) at a pre-determined price/pricing mechanism at a future date or on the occurrence of an event. For instance, as an alternative to the call option, a put option is generally mentioned in the shareholders' agreement as a consequence of an event of default by a shareholder where the shares of a non-defaulting shareholder are purchased by the defaulting shareholder at a premium.

Call and put options, as the consequences of an event of default, are used as deterrents.

9. In India, do by-laws tend to be tailor-drafted or do they tend to use standard formats?

Articles of association (by-laws) are mostly drafted using standard formats given under the Indian Companies Act depending on the nature/constitution of the company. However, depending on the circumstances, the articles of association can also be tailor-drafted. For instance, in the case of third-party/institutional/strategic investors who are granted special rights under the shareholders' agreement, the articles of association are tailor-drafted to incorporate such rights.

10. What are the motives in India for executing shareholders' agreements?

Shareholders' agreements are executed to govern the relationship *inter se* the shareholders of a company and lay down clearly defined rights and obligations between the parties regulating governance, management, share transfers and exercise of voting rights at the meeting of the board of directors and the meeting of the shareholders, by the shareholders of the Indian company, in an agreed manner.

11. What contents tend to be included in shareholders' agreements in India?

Shareholders' agreements are commercial contracts and the parties are free to agree on such terms and conditions that they may deem appropriate. Typically, in India, shareholders' agreements include the following:

1. appointment/removal of directors;
2. quorum and notice requirements at the meeting of the board of directors;
3. quorum and notice requirements at the meeting of the shareholders;
4. affirmative voting at the meeting of the board of directors;
5. affirmative voting at the meeting of the shareholders;
6. capital contribution and other contributions to be made by each shareholder in the company;
7. pre-emption and anti-dilution rights;
8. management team of the company;
9. information and inspection rights of the shareholders;
10. determining the matters requiring special resolution or providing veto rights to certain shareholders;
11. deadlock resolution;
12. financing waterfall of the company;
13. exit mechanism;
14. restrictions on the transfer of shares;
15. non-compete and non-solicit obligations of the shareholders towards the company and each other;
16. events of default and its consequences including call and put options;
17. fall away of rights;
18. term and termination; and
19. governing law and dispute resolution mechanism.

As mentioned in our response to Question 3, it is pertinent to note that the provisions of the shareholders' agreements of the Indian company are required to be incorporated in the articles of association to bind the company and other shareholders *inter se* who are not parties to the shareholders' agreement.

12. What determines the content included in shareholders' agreements in India?

A shareholders' agreement typically grants special rights to those shareholders who are parties to the shareholders' agreement. These special rights are in addition to the rights granted by the Indian Companies Act, which are inherent to the shares that they own. It

is intended to ensure that those shareholders obtain the benefits of such special rights as a consideration for value added by them to the company by their experience/expertise/valuation attributed by them to the company. For instance, shareholders' agreements may allocate among certain shareholders rights to designate the individuals who will serve on the company's board of directors and affirmative voting rights for the directors nominated by them at the board of directors of the company, grant certain shareholders special voting rights, ensure that certain shareholders have pre-emptive rights if the company issues additional shares, and/or provide rights to limit or participate in transfers of shares by other shareholders.

13. What are the most common types of clauses in shareholders' agreements in India?

Please see our response to Question 11.

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

The articles of association of an Indian company may provide for the appointment of not less than two- thirds of the total number of directors of a company in accordance with the principle of proportional representation. The concept of proportional representation facilitates the possibility of each group of shareholders having their representatives on the board of directors of the company in proportion to their voting power in the total share capital of the company. In addition, Indian law permits special rights to be granted to minority shareholders by way of a contract. For instance, PE/VC investors (largely being minority investors in a company) are granted special rights through a shareholders' agreement with the company and other shareholders (including promoters).

15. Is it possible in India to ensure minority shareholder control by means of a shareholders' agreement?

The Indian Companies Act defines the term 'control' to mean to include the right to appoint the majority of directors, or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights; or shareholders' agreements or voting agreements; or in any other manner. Therefore, by way of a shareholders' agreement, minority shareholders can be given power to appoint the majority of directors on the board of directors of a company, and/or granted such voting rights at the board meeting and shareholders meeting such that minority shareholders, through directors or authorised representatives nominated by them, exercise an affirmative vote on matters relating to management or policy decisions to be decided at the meeting of the board of directors or general meeting of the shareholders of the company.

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

Indian law prescribes no set valuation method to be used for determining fair market value in the case of the issue/transfer of shares. The Indian Companies Act and Indian Foreign Exchange Regulations provide for the usage of 'internationally accepted valuation methods'. Typically, the 'net asset value' method and 'discounted cashflow' method are most commonly used valuation methods in India for determining the fair market value of shares.

For determining a fair valuation under Indian income tax laws, the following methods are prescribed for the valuation of shares of an unlisted company: (1) net asset value method; (2) discounted cashflow method; (3) comparable company multiple method; (4) probability weighted expected return method; (5) option pricing method; (6) milestone analysis method; and (7) replacement cost method.

The 'net asset value' method values shares based on the company's net assets, which includes tangible and intangible assets.

The 'discounted cashflow' method of valuation is used to estimate the attractiveness of an investment opportunity. This analysis uses future free cashflow 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 'comparable company multiple' method is a process used to evaluate the value of a company using the metrics of other businesses of a similar size in the same industry.

The 'probability weighted expected return' method is a multi-step process in which value is estimated based on the probability-weighted present value of various future outcomes.

Under the 'option pricing' method, common shares would have material value only to the extent that the residual equity value remains after the satisfaction of the preferred stock's liquidation preference at the time of a liquidity event.

The 'milestone analysis' method involves identifying specific milestones that a company aims to achieve in its business plan or development roadmap.

The 'replacement cost' method is a valuation method that estimates the fair market value of shares by considering the cost of replacing the company with a similar company.

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

An Indian company operating in India is, by law, required to comply with the Indian Companies Act and other Indian laws, like the Indian Contract Act, Indian labour laws and Indian environmental laws. An Indian company cannot contract out of complying with these Indian laws. It is advisable to have Indian governing law in the shareholders' agreement as opposed to a foreign governing law. It is difficult, time-consuming, expensive and challenging to enforce a contract governed by foreign law in India. If the

shareholders' agreement is governed by foreign law; if there is a breach of the provisions therein by any of the parties; and if any action is to be initiated by any non-defaulting party against the defaulting party for breaching the terms of the shareholders' agreement in an Indian court, then the affected party is required to prove the foreign law governing the shareholders' agreement as a matter of fact by leading the evidence of the foreign counsel. This will considerably delay any application for interim relief of the non-defaulting party against the defaulting party. If the Indian courts have jurisdiction to try and entertain a legal action arising out of any disputes between the parties under the shareholders' agreement, the parties cannot take away the jurisdiction of the Indian courts by submitting to the jurisdiction of a foreign court.

Any clause conferring jurisdiction on a foreign court may not be upheld by the Indian courts if, on the facts of the case, a legal action is brought in a competent Indian court, and if such an Indian court holds that the ends of justice would be better served if such suit were allowed to be tried in that Indian court. In addition, foreign courts would not be qualified to adjudicate on Indian laws and vice versa. An order of injunction given by a relevant court is valid only within the jurisdiction of such a relevant court and cannot be enforced outside the jurisdiction of the relevant court.

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

The (Indian) Arbitration and Conciliation Act and Conciliation Act ('Indian Arbitration Act') is based on the United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration. If there is a foreign award and if the arbitration proceedings are conducted in a place that has been notified by the Government of India as a reciprocating territory under the provisions of the Indian Arbitration Act for the purpose of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards or under the provisions of the Indian Arbitration Act for the purpose of the Geneva Convention on the Execution of Foreign Arbitral Awards, such an arbitral award can be enforced as a decree of the court in India subject to the Indian Arbitration Act specifying the conditions for the enforcement of foreign awards passed in reciprocating territories.

Consequently, the parties to the shareholders' agreement can agree to resolve their disputes by arbitration with the seat of arbitration in one of reciprocating countries under the New York Convention/Geneva Convention as explained above, such as Singapore, London, Paris or New York, and such arbitration can be conducted in accordance with institutional arbitration rules, such as Singapore International Arbitration Centre (SIAC), London Court of International Arbitration (LCIA), International Chamber of Commerce (ICC) or American Arbitration Association (AAA) Rules, respectively. We have observed a recent trend by which Indian courts have been in favour of enforcing foreign awards passed in foreign seated arbitrations and have been loath to interfere with such foreign

awards. As regards the shareholders' agreements containing any law other than that of India, please see our response to Question 17.

It is also advisable to incorporate the arbitration provision in the articles of association of company so as to bind the corporate entity and its shareholders *inter se*. Having said that, all shareholder disputes may not be arbitrable and therefore, cannot be arbitrated under the arbitration provision contained in the shareholders agreement. For instance, certain courts in India have held that disputes in relation to oppression and mismanagement by majority shareholders in relation to a company are not arbitrable as the Indian Companies Act provides for a specific remedy regarding this in favour of the minority shareholder.