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Venture Capital and Private Equity: In the Indian Legal Perspective

MADHAVRAJE PATWARDHAN[1]

ABSTRACT

India is an emerging market that continues to be a hot spot for investment. With 1.3 billion people and growing, India has the potential to become one of the top economies in the world. But it's not just about economics; it's about people and their needs. And those needs are changing rapidly over the past decade. The Indian government has made a conscious effort to encourage entrepreneurship by providing incentives like tax cuts, cheaper loans, and better access to education, among other things. It's also trying to make its citizens more self-reliant by encouraging them to start their own businesses rather than rely on government jobs. These changes have led to a huge increase in small businesses opening up in India over the last few years—and they're getting bigger all the time! According to one estimate by McKinsey & Company, there were 32 million small businesses around India in 2014; by 2018, that number had grown almost 50 per cent!

Keywords: *Venture Capital, Private Equity.*

I. INTRODUCTION

(A) Need of Funds in a body corporate

Businesses need money and resources for various reasons, mainly for their expansion and speedy growth.

Two types of capital generally available to businesses are debt and equity.

Debt capital refers to funds borrowed by the company from banks, financial institutions or investors and forms a part of the company's total capital. It has to be repaid by the company, and generally, interest is charged on the borrowed amount.

On the other hand, equity capital refers to money the company gets from subscriptions to its shares. This is also called the permanent capital of the firm. The shareholders are rewarded with dividends, bonus issues and certain other benefits._ As this form of capital is not repaid, shareholders can exit via buybacks or sell their shares either in the market or otherwise.

Venture capital can be in the form of either equity or debt; known as venture debt, quite rare

[1] Author is a student at ILS Law College Pune, India.

 [ISSN 2581-5369]

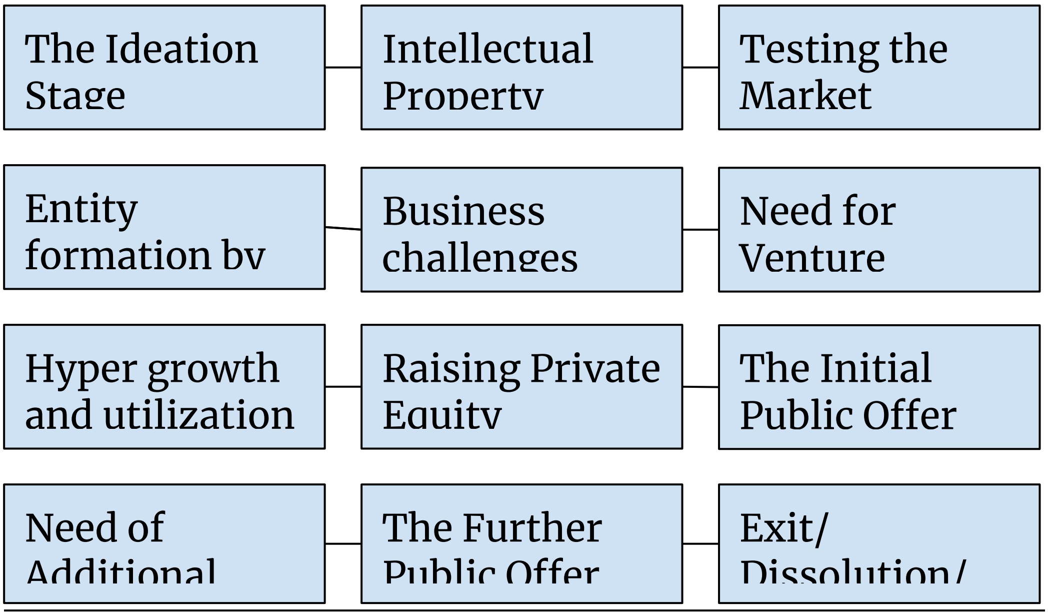
but possible.

Private equity can also be in the form of convertible debentures but generally refers to equity.

(B) The life of a corporate

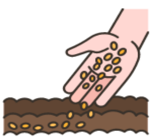
When a lawyer analyses a company or the promoter of the company to give his advice, he is often unaware of the stage of its life.

Understanding the different stages in the business from a legal standpoint can help lawyers give better advice to their clients and get a higher rate of client satisfaction.



a. **The ideation phase**

The first stage in the life of a business is the ideation stage. A business can only happen once there is an idea or a concept to work on. Hence, with the existence of an idea there is no scope for business-related activities, and hence a lawyer is optional at this stage.



The Ideation Stage

Need for VC

b. Intellectual Property Protection

After the ideation stage, a lawyer may be employed for patent protection and trademarking. It is crucial that, at this stage, the lawyer gives the right kind of advice to his client to ensure the successful flight of the business. A Patent is used for the protection of designs. A trademark is used to protect the misuse of the brand or the way the firm's goodwill is perceived. And lastly, copyrights are used to protect the interests of authors and writers, be they books or computer codes.

c. **Market test and initial work-**

Once the ideation stage is over and the concepts are prepared, founders must take a trail of the product or service amongst the prospective consumers. Entrepreneurs can use various methods to understand the market sentiment of the end user, like market sample testing, promotional distributions and surveys. Some other popular methods include using tools like Kickstarter. The correct way depends on the circumstances of each case.

d. Entity formation by founders- corporate structuring

The structuring of the business vehicle is the most critical and gruelling phase for a lawyer. Selecting the proper method from the beginning can make or break the trajectory of the business, especially when dealing with businesses with more than two founders and many early-stage investors. Devising a mechanism to protect the rights and interests of each stakeholder can be the most challenging task. This is not a one shoe fits all answer and is to be taken lightly by just suggesting a company formation. This is a common mispractice that many lawyers undertake.

Considering the stakeholders, a combination of entities needs to be used to protect the interests of the various stakeholders. These could include holding companies, trusts, LLPs, Partnership firms, HUFs, DVR shares etc in such a combination that the board of the business enterprise has the least number of directors and that the holding bodies have representation from the stakeholders.

An illustration below:

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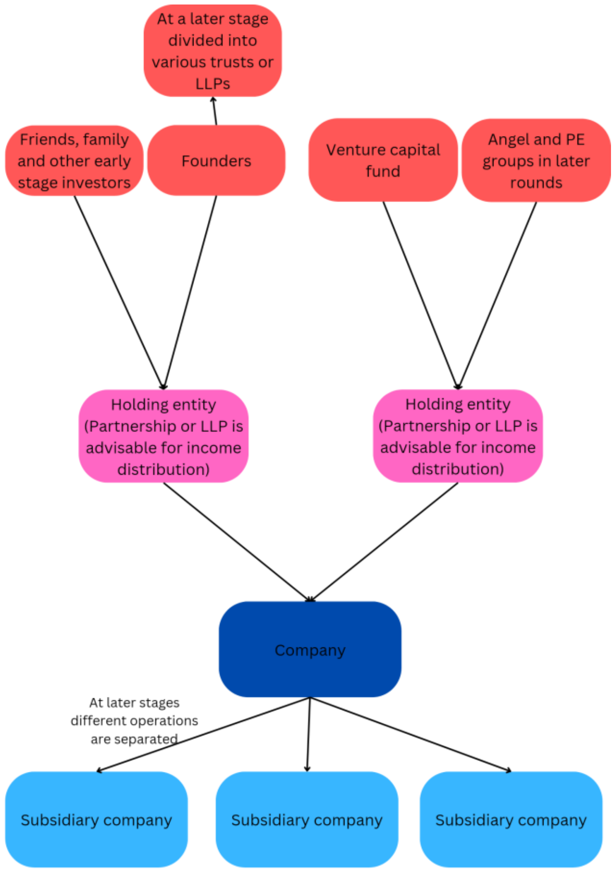

e. Challenges in functioning

There comes a time in the life of a business when the technical and financial resources of the company aren't sufficient to fulfil its needs. This could be operational inadequacy or lack of cash to fund the orders received. At an early stage of the business, it is often difficult for the enterprise to secure debt capital and secure the services of a management consultant.

f. Venture capital

In the early stages of a startup, businesses should go for venture capital funding. Venture capital funding enables founders to get money to fulfil their short-term or long-term requirements and get an experienced businessman or in some cases, a management consultant to help them scale the business. Many venture capitalists also run incubators, where startups are clustered together, creating a conducive ecosystem. Like an IT hub that provides centralised office facilities and other technical facilities, so that young founders and businesses in their nascent stages may focus on their core activities.

Venture capital can be provided in the form of equity or debt capital. In many cases, it is provided as a combination of equity, debt and services which are remunerated in the form of shares. These services could be in the form of business support services or rent-free space in an incubator.

g. Growth of company or usage of funds

This is more a transitional face in between the time the company receives its funding and consultancy and finishes the resources or has completed all its rounds of funding and has more than a certain number of investors or has matured from a startup to a regular business.

Depending on the stage and age of the business, various valuation methods can be used based on revenue, profit, market share etc.

h. Private Equity

It is technically an umbrella term for VC, Listed securities and unlisted shares. However, it generally refers to investments made in mature and stable businesses. On the other hand, venture capital is done at the early growth stages.

2(r)―private equity fund‖ means an Alternative Investment Fund which invests primarily in equity or equity-linked instruments or partnership interests of investee companies according to the stated objective of the fund;[2]

i. Initial Public Offer

"An initial public offering (IPO) refers to the process of offering shares of a private corporation to the public in a new stock issuance for the first time. An IPO allows a company to raise equity capital from public investors."[3] It also allows existing investors to exit their positions. In practice, before the company goes for an IPO, it is already a public company registered under the companies act; however, an IPO indicates that shares of this company are now listed on a recognised stock exchange, i.e. the NSE or BSE. Previously there were many more stock exchanges all over the country, but after the NSE's establishment, the others have become redundant.

While looking at an IPO, it is important to understand the concept of NFO and the two, which are used synonymously when they are very different. An NFO or a new fund offer is the process of listing Mutual fund units on recognised stock exchanges. While an IPO refers to the creation of new shares via a new issue or the exit of existing investors, an NFO contemplates the collection of funds by the Mutual fund house for the purpose of already traded securities. It can also be looked at as a call for a corpus and a start of the fund. An IPO on the other hand is only permitted after the company has started its operations and in many cases turned a profit.

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[2] ("SEBI (Alternative Investment Funds) Regulations, 2012 [Last amended on March 6, 2017]")

[3] (Fernando)

j. **FPO/ Preferential Placement/Rights issue -**

After the IPO, the company generally stabilises for a while before needing this round of funding.

This happens in rare cases like with, the idea-Vodafone, where a Preferential Placement was made to ease the debt of the company or in Yes Bank after it suffered losses; here other banks were asked to subscribe to its capital. An FPO is effectively the same as a Preferential Placement except it is done directly via the stock exchanges and the public at large is invited to subscribe to additional shares.

A rights issue is another type of this event where only the existing shareholders are permitted to subscribe to fresh capital as in the case of Tata steel.

k. Dissolution, liquidation or exit

The final stage in an investor's journey with a corporation is either because of dissolution of the company as per 302 section of the companies act or because of liquidation as per section 59 of the Insolvency and Bankruptcy Code or by a strategic exit.

While in the first two cases the role of the investor is often involuntary and this results due to a management decision, the third case is interesting as the investor makes an educated decision to end his relationship with the company.

Theoretically, an exit can take place at any time after the ideation stage provided a person is ready to buy the stake. It is practically done during the VC, PE or IPO round or via a sale in the open market after the IPO.

II. What is an Incubator?

Venture Capital funding is different from traditional sources of financing. Venture capitalists finance innovation and ideas which have the potential for high growth but with inherent uncertainties. This makes it a high-risk, high-return investment. Apart from finance, venture capitalists provide networking, management and marketing support as well. In the broadest sense, therefore, venture capital connotes risk finance as well as managerial support. In the global venture capital industry, investors and investee firms work together closely in an enabling environment that allows entrepreneurs to focus on value-creating ideas and venture capitalists to drive the industry through ownership of the levers of control in return for the provision of capital, skills, information and complementary resources. This very blend of risk financing and hand-holding of entrepreneurs by venture capitalists create an environment particularly suitable for knowledge and technology-based enterprises.[4] -K B Chandrashekar report

In short, an Incubator is a special environment created by the venture capitalist or VC firm for the start-up to benefit from an ecosystem along with other startups that they may have provided funding to. This enables the start-up to get help in the areas the founders may not be proficient. In a technology start-up for example the promoter founder may not be proficient in operations or other office-related tasks, and an agricultural start-up may not have computer expertise. It may need help in creating an app or a website.

III. Laws applicable to venture capital and private equity

1. SEBI- AIF (Alternate investment fund) guidelines 2012[5]

Category I AIF:

a. **Venture capital funds** (Including Angel Funds)

Venture capital fund means an Alternative Investment Fund which invests primarily in unlisted securities of start-ups, emerging or early stage venture capital undertakings mainly involved in new products, new services, technology or intellectual property right based activities or a new business model [and shall include an angel fund as defined under Chapter III-A]

(aa)—venture capital undertaking means a domestic company:

(i) which is not listed on a recognised stock exchange in India at the time of making investment; and

(ii)Which is engaged in the business for providing services, production or manufacture of article or things and does not include following activities or sectors:

(1) non-banking financial companies

(2) gold financing;

(3) activities not permitted under industrial policy of Government of India;

(4) any other activity which may be specified by the Board in consultation with Government of India from time to time.[6]

b. **SME Funds**

SME fund means an Alternative Investment Fund which invests primarily in unlisted securities

[4] (“Report of K.B. Chandrasekhar Committee on Venture Capital”)
[5] (“SEBI (Alternative Investment Funds) Regulations, 2012 [Last amended on March 6, 2017]”)
[6] (“SEBI (Alternative Investment Funds) Regulations, 2012 [Last amended on March 6, 2017]”)

of investee companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on an SME exchange or SME segment of an exchange;

The SME platform of the Exchange is intended for small and medium-sized companies with high growth potential. The SME platform of the Exchange shall be open for SMEs whose post-issue paid-up capital shall be less than or equal to Rs.25 crores. The platform is expected to offer a new and alternate asset class to informed investors having longer investment horizons. The platform shall allow new, early-stage ventures and small-quality companies to raise much-needed growth capital as they mature and transit to the Exchanges' main board.[7]

It is a new and exciting project that enables experienced and HNI investors to invest in new and cutting-edge technologies and companies. Both the NSE and the BSE have this platform.

c. **Social Venture Funds**

—*social venture* means a trust, society or company or venture capital undertaking or limited liability partnership formed with the purpose of promoting social welfare or solve social problems or providing social benefits and includes:-

(i) public charitable trusts registered with Charity Commissioner;

(ii) societies registered for charitable purposes or for promotion of science, literature, or fine arts;

(iii) company registered under Section 25 of the Companies Act, 1956;

(iv) microfinance institutions;

—*social venture fund* means an Alternative Investment Fund which invests primarily in securities or units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns;

This section is mainly concerned with investment in section 8 companies and the like in the early stage of their inception. This provision can be used in funding international NGOs that set up their operations in India. Another use case could be for the initial funding of NBFCs (Non-Banking Financial Companies) that are incorporated as charitable trusts or as societies.

d. **Infrastructure funds**

—infrastructure fund means an Alternative Investment Fund which invests primarily in unlisted securities or partnership interest or listed debt or securitized debt instruments of investee companies or special purpose vehicles engaged in or formed for the purpose of operating,

[7] ("National Stock Exchange of India Ltd.")

develop or holding infrastructure projects;

2. **Category II AIF - Various types of funds such as real estate funds, private equity funds (PE funds), funds for, distressed assets, etc**

AIFs which do not fall in Category I and III and which do not undertake leverage or borrowing other than to meet day-to-day operational requirements and as permitted in the SEBI (Alternative Investment Funds) Regulations, 2012. [Ref. Regulation 3(4)(b)] Various types of funds such as real estate funds, private equity funds (PE funds), funds for distressed assets, etc. are registered as Category II AIF#

3. **Category III AIF - Leveraged Funds**

Leveraged funds as the SEBI regulations refer to funds that rely on external debt funding on the equity subscriptions to the fund in order to enhance the returns for the investors.

The below table shows an illustrative example:

Sr No	Equity subscription either paid up or callable	Debt that can be used for leverage
	2000 Cr	4000 Cr
	1	2

These funds are very similar to the private equity funds in terms of securities that they can invest in. The main difference is, however that they are permitted to borrow money to enhance their returns.

Using the above example, suppose 2000 Cr is raised as equity; the fund is allowed to borrow 4000 Cr. In accordance with the legal provision that 2 times the equity capital may be borrowed. Let us assume a 10% interest rate on the 4000 Cr and a return of 15% on the total investment of 6000 Cr is 900 Cr [8]

However as of date there is no publicly traded leveraged fund in India. These funds have to solicit clients privately like in the case of private equity funds and cannot make an offer to the public.

IV. Types of Venture Funds

1. Venture Debt funds

Venture debt means and includes the obligations a company would undertake to repay the

[8] [Ref. SEBI circular No.CIR/IMD/DF/10/2013 dated 29th July, 2013]

capital given to it for growth.

In the capital markets, it is a common practice to issue convertible debentures, which can be in the form of venture debt. This helps secure the interest of the investors in the early stages of the business. These debt obligations can be converted into equity upon the completion of a specified period or on the execution of a particular event.

Non-convertible bonds/ debentures are another mode of this kind of funding.

Venture Debt is considered a relatively safer investment and for that reason, is not a preferred mode of investment for the investee.

Debt fund is an Alternative Investment Fund (AIF) which invests primarily in debt or debt securities of listed or unlisted investee companies according to the stated objectives of the Fund. [Ref.]. These funds are registered under Category II. In this regard, it is clarified that, since Alternative Investment Fund is a privately pooled investment vehicle, the amount contributed by the investors shall not be utilised for purpose of giving loans. [9]

This is governed by regulation 2(1)(i) of the SEBI AIF Regulations 2012

2. Equity funds -

These are effectively the traditional venture capital funds, dealing in the equity shares or the rights in equity shares of private companies. Sometimes these can also invest in public companies that aren't listed on the recognised stock exchanges i.e. the BSE and NSE. These kinds of shares are generally illiquid and difficult for retail investors to enter and exit at the correct prices. Venture funds can solve this problem as they are able to push their weight around in the management of such a firm and have the required resources to either find a buyer for their shares or take the company public.

3. Leveraged Funds

As per circular No.CIR/IMD/DF/10/2013 dated 29th July, 2013, the leverage of a Category III AIF shall not exceed 2 times the NAV of the fund. [Ref. circular No.CIR/IMD/DF/10/2013 dated 29th July, 2013]

4. Angel funds

“Angel fund” is a subcategory of Venture Capital Fund under Category I- Alternative Investment Fund that raises funds from angel investors and invests in accordance with the provisions of Chapter III-A of AIF Regulations. In the case of an angel fund, it shall only raise

[9] (“FREQUENTLY ASKED QUESTIONS (FAQs)”)

funds by way of issue of units to angel investors.

"Angel investor" means any person who proposes to invest in an angel fund and satisfies one of the following conditions, namely,

(a) an individual investor who has net tangible assets of at least two crore rupees excluding value of his principal residence, and who:

(i) has early stage investment experience, or

(ii) has experience as a serial entrepreneur, or

(iii) is a senior management professional with at least ten years of experience; ('Early stage investment experience' shall mean prior experience in investing in start-up or emerging or early-stage ventures and 'serial entrepreneur' shall mean a person who has promoted or co-promoted more than one start-up venture.)

(b) a body corporate with a net worth of at least ten crore rupees; or

(c) an AIF registered under these regulations or a VCF registered under the SEBI (Venture Capital Funds) Regulations, 1996. Angel funds shall accept, up to a maximum period of 3 years, an investment of not less than `25 lakh from an angel investor.[10]

5. Registered and unregistered funds

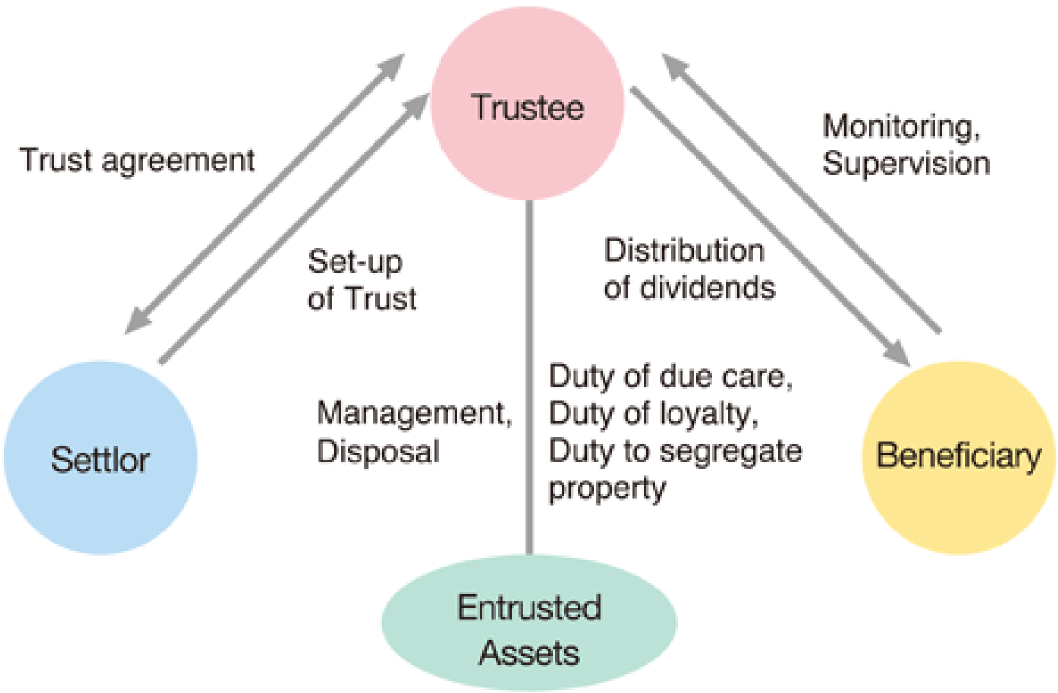
This is a point of contention of its own; turn or not a venture fund can remain as an unregistered entity and its legal implications. However, for this work, we will not consider the possibility of an unregistered entity.

V. VARIOUS STRUCTURES USED FOR VENTURE CAPITAL

1. Trust

Most of the AIFs that are registered with the SEBI are in the trust form; it is important to understand how they are structured.

[10] What is 'Angel Fund'? ("FREQUENTLY ASKED QUESTIONS (FAQs)")



In a regular trust, there is a settler, the person who puts down his capital,the it trustee, the person that manages the money and a beneficiary, a person who enjoys the profits and the Corpus. In the case of venture capital or most investment-related schemes, the settler is generally the beneficiary. It is also important to note that no such provision debars a settler from being the beneficiary under the Indian trusts act.

Now in our example this settler com beneficiary is known as the unit holder and like in the case of a trust where the beneficiary has certain rights and obligations that he can impose on the trustee, our unit holders also have certain powers that they can execute against the trustee or in our case AMC(Asset Management Company) or venture capital manager.

2. Partnership and LLPs

This form of AIF structure is more democratic than the trust form. However, there are many risks associated with them. Most Angel investors prefer this kind of structure so they can be in power and have the same management right as their counterparts.

Since the inaction of the LLP act LLP is greatly preferred over partnerships.

In this structure, the partners come together and invest the pool of funds either directly in companies or pool their funds and purchase units in a larger venture fund like shown above in the trust structure.

3. Companies

Companies are growing in importance and now the SEBI has allowed companies to be directly registered with it, as vehicles for venture capital.

VI. Documents used by lawyers

1. MOU/ Term sheet/ LOI

This is one of the most common documents in equity investment. An MOU or a memorandum of understanding is a two-party agreement; one party is the investor, and the other is the investee. The investor agrees to pay the investee a sum of money as consideration for shares.

This generally serves as an interim agreement after the execution of this agreement, and the payment of a token allows the investor some time to conduct due diligence and other legal compliances.

The contents of this agreement, like a standard contract, have clauses containing the background of the parties, the business of the company, obligations to be fulfilled by either party, a schedule of how the payments will be made and shares to be issued. In some cases this will be the final agreement, however, it might be an interim arrangement so a clause to state the date and requirements to executing the final sale of shares may also be added.

2. Business transfer agreements

A BTA is separate from a slump sale of assets; while the effects are similar, there are distinct differences. Only the assets are sold to the vendee company in a slump sale. And in general parlance, the vendor hopes to purchase the assets of the sick and distressed vendee company at a severe markdown.

In a business transfer agreement, the assets and liabilities are sold to the vendee company. Such agreements are specifically used in Mergers and Acquisitions and conversion transactions wherein partnerships or proprietorships are converted into companies.

3. Shareholders agreements:

A shareholders' agreement definition states that it is a contract between the shareholders of a company and the company itself. Also known as a shareholders' agreement, is an arrangement that regulates the relationship between the shareholders, the management of the company, ownership of the shares, rights, obligations, and protection of the shareholders. It may also command how the company is run.[11]

In many cases, the promoters or the investors may not have enough voting shares to take part in the control and management of the company. A shareholders agreement enables the smooth

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[11] ("What is a Shareholders' Agreement? | IIFL Knowledge Center")

regulation of control and management without the minority shareholders left feeling dissatisfied or cheated. It also clearly defines the roles of individuals in terms of finances or personal service.

For example, an Angel investor is brought into a technology company to provide funds for the company to grow. However, he may need to be given a controlling interest, i.e. more than 26% of the company. In order to limit his involvement in the company, a shareholders agreement can be drafted.

In another case, a heavy industry may need technical know-how to adapt to the digital world. This technical person could be brought on by issuing some sweat equity but not having a controlling interest in the company. A shareholders agreement can bind him to give expertise in the technology field.

There can be various kinds of shareholder agreements. Some of them are listed below:

1. Non-dissolution agreements
2. no-dissolution agreements
3. Voting agreements
4. Other shareholders agreements

VII. Venture Capital in India

India is an emerging market that continues to be a hot spot for investment. With 1.3 billion people and growing, India has the potential to become one of the top economies in the world.

But it's not just about economics; it's about people and their needs. And those needs are changing rapidly over the past decade.

The Indian government has made a conscious effort to encourage entrepreneurship by providing incentives like tax cuts, cheaper loans, and better access to education, among other things. It's also trying to make its citizens more self-reliant by encouraging them to start their own businesses rather than rely on government jobs.

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VIII. Conclusion

The India Venture capital and private equity space is a fast-changing and ever-evolving space with laws that are not completely geared towards it. Like any nascent industry, the laws of the

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high seas are now being penned down, and some inspiration from already-developed economies will most certainly help in further development.

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