

Investor Protection Rights vis-à-vis Founders' Rights
-Investment Agreements-

India's start-up sector is snowballing with new start-ups setting up every other day with novel business ideas. Also being witnessed is the considerable public investments, and listing of the start-ups that has turned into a unicorn in a short span.

Every start-up requires funding and there are Investors who are looking to invest in start-ups with business ideas matching their investment objective. Resultingly, negotiations on terms of a prospective Investment Agreement (Share Subscription and Shareholders Agreement) commences between the Founders and Investors wherein their respective rights and obligations are discussed and decided upon.

This article focuses on certain Investment Protection Rights (other than the Exit Rights) sought by the Investors while investing in the start-up or any mature company. The Article also emphasizes on when and where the Founders must draw a line while providing such protection rights to the Investors.

IMPORTANT CLAUSES

1. Pre-Emptive Right

Pre-Emptive Right is a right providing for the first right to participate in a company's (start-up's) future issuance and protecting the Investor from dilution of its shareholding. A Pre-emptive Right provides for a right (and not an obligation) to an Investor and/or to a Founder (that is, the existing shareholder) to participate in any further primary issuance of shares or convertible securities of the Company on *pro-rata* basis. The right effectively intends to give the first right to an Investor and/or to a Founder, as the case may be, to invest in the company's future issuance. The right is sought by the Investors to always have the opportunity reserved with them, where they see the growth in the Company and wishes deter the entry of any third-party in the Company, thereby, protecting their equity proportion in the Company. The following essential aspects may be considered by the Founders and Investors while deciding on the Pre-emptive rights:

- i. The Founders may also seek the pre-emptive rights as sought by the Investors;
- ii. In the event, an Investor or Founder choose not to exercise such right, his portion of shares or convertible securities may be offered to other existing Investors and/or Founders on a proportionate basis before the same is offered to any third-party;
- iii. The pre-emptive right shall sustain till the Company goes for Initial Public Offering (IPO). Such right must not be applicable for participation under an IPO;
- iv. The pre-emptive right must be exercised at the same or preferred terms and price as are proposed to be offered to any third-party;
- v. The pre-emptive right shall be confined for exercise within a predetermined period, that is, a Founder or Investor, as the case may be, must exercise the pre-emptive right within a predetermined timeline envisaged in the Investment Agreement;

It is noted that every Investor looks for the pre-emptive right to protect from any potential future dilution. However, exercising such a right is based upon the Investor's evaluation of the future potential of the Company. The non-exercise of the pre-emptive rights does not reduce the valuation of the equity holding of the Investor unless the future issuance is made at the price lesser than at which such Investor invested.

2. Right of First Refusal

The Right of First Refusal ("ROFR") is a right intended towards having the right not only to increase the shareholding and control in the Company by acquiring the shares of the existing shareholder wishing to divest but also to deter the entry of any third-party into the Company. ROFR puts an obligation on the Founder and/or other existing shareholder of the Company who intends to divest (that is, the selling shareholder) by requiring him to offer such shares or convertible securities first to the Investors and/or other existing shareholder, as the case may be, for purchase in the manner or proportion as agreed in the Investment Agreement. The rights deter the entry of any third party (external Investor) until the existing Investors or the existing shareholders allow such entry by not exercising their ROFR with respect to any number of shares offered to them for purchase. In an event where the ROFR holder does not exercise the rights or refuses to purchase, the selling shareholder may decide to transfer the shares to any third party but on the same or less privileged terms as were offered to ROFR holders. The Founders and Investors may consider the following essential aspects in an Investment Agreement:

- i. Founders may seek exemption from ROFR for transfer of a specific percentage of shares to their affiliates as a part of succession planning;
- ii. The *inter se* transfer between the Founders/promoters may be sought without triggering ROFR;
- iii. Restriction of sale of shares by the Investors to any competitor;
- iv. Right to exercise ROFR shall be available for predetermined time prescribed in the Investment Agreement;

3. Anti-Dilution (Price Protection)

The Anti-Dilution provides for the price protection to the Investors from any future down round investment in the company. In any event of such down round investment, the price at which allotment was made to the Investor will be adjusted to such down round price and accordingly the additional shares will be issued to the Investors, thereby protecting the dilution of their investment value.

The down round investment occurs when the subscription price of further issuance of shares or convertible securities by the Company is at a price lower than such subscription price of existing Investors. The Anti-Dilution rights protects the Investors from such event of down round investment by requiring the company or the Founders to allot/ transfer such number of shares

as to adjust the subscription price of the Investors to such lower subscription price.

In such event of down round, the issuance of shares to existing Investors can be in any of the two mechanisms, that is, (i) Full Ratchet (ii) Broad Based Weighted Average, with each mechanism having its own features and advantage.

It is to be noted that such Anti-Dilution rights are not available to the foreign Investors since the foreign exchange laws of India (Foreign Exchange Management Act 1999) prohibits any issuance of shares at a price lower than the fair valuation, and thus any issuance or transfer of any additional shares against price adjustments.

The Founders and Investors may consider the following essential aspects in an Investment Agreement:

- i. Price adjustments to be made on basis of Full Ratchet or Broad Based Weighted Average methodology. The Investor would always seek Full Ratchet Anti-Dilution rights, while the Broad-Based Weighted Average are sought by the Founders to average the issue of the additional shares against price adjustments and is widely accepted;
- ii. The foreign Investors are not protected through Anti-Dilution rights;
- iii. The Anti-Dilution rights shall be restricted to provide for price adjustments against the subscription price at which an Investor has made the investments.

4. Lock-In (for Start-Ups)

Lock-in prohibits the transfer of shares or convertible securities held by the Founders for a prescribed period or until the happening of any specified event. In the interest of Founders, the Lock-In provisions may provide for the transfer by Founders *inter se* or their affiliates. Further, the vesting schedule, that is, the schedule providing for a timeline for gradual unlocking of shares/convertible securities in tranches must be decided carefully to balance the risks of Investors and interest of Founders. Any extension of the Lock-In period may be expressly provided by virtue of any new investments either by existing Investor or any new incoming Investors.

The Lock-in provisions shall exhaustively provide for the situations where any Founder intends to sell his shareholding during the period of Lock-In to any third-party. Such provisions shall be defined, vis-à-vis, the following:

- Applicability of Right of First Refusal of Investors, wherein the selling Founder shall offer its shareholding first to the Investors or other Founders;
- Price at which the shares of selling Founders be purchased by Investors, that is, face value, fair value or other predetermined value.

It is noted that this is one of the most critical among all investment protection rights of the Investors with respect to their investments in start-ups considering the risk involved, since though

the investments were made in the start-up but in actual the same is made in the person who is operating and managing such startup.

- 5. Reserved Matters:** Reserved Matters are specifically enlisted matters and businesses of Company in regards to which any decision shall require express compulsory approval of the Investor(s), whether through its board representative or through representation in shareholder meetings. The Founders must ensure that compulsory approval may be required only for very restricted matters or business and shall be limited to those matters that directly affect the rights of the Investor(s) or in the form of the structural changes to the subject company. Further, such right to the Investor(s) may be vested only as long as such Investor(s) holds a specific threshold of the shareholding in the Company. Reserved Matters must not comprise of business matters of day-to-day operations, as the compulsory approval of Investors on each occasion may hamper the business operations.
- 6. Board Composition:** Any Investor investing in the Company may seek for compulsory appointment of director(s) nominated by such Investor on the board of the Company and presence of such director to form quorum for the meetings of the Board.

Any such rights are generally sought by the Investor possessing substantial shareholding in the Company, and in pursuance to which such Investor desires to participate or have information on the business decisions of the Company with a view to protect his investments. All such reserved matters shall require the approval of such Investor nominated director. To be precise, such a right to nominate is intended towards enforcing the limited control of Investors in the Company. However, the Founders shall also consider that the Company may need additional funds in future, and any incoming Investor may also demand such board rights. Therefore, it is important to frame the balance between the Founders as directors and Investors' representative as directors. Also, deliberated decisions must be taken concerning quantum of the veto powers to be granted to any Investor nominated director, and the matters on which such veto may be provided.

- 7. Permitted Transfers/Affiliate Transfers:** These are the expressly allowed transactions as a part of succession planning that may be available to a shareholder (including Founders and Investors), wherein any sale to permitted parties or affiliates, that is, parties expressly specified to be as such, shall not trigger certain exit rights, or any other right, as may be available to the Investors. However, such transfer of shares shall be limited to a small percentage of shares, and shall not act as an exit mechanism or divestment of a major chunk of shares by any Founder.

Every business operates with moneys invested into it, and by investing into the Company, every Investor looks for all rights to protect such investment and facilitate exit at the right time. Similarly, every business runs on an innovative idea and the effective implementation of such idea by the Founders of such a business. Thus, it is both the Founders and the Investors that play important roles in the development of the business through their respective means with a view to earn profits, so it is important to frame a balance of the rights of both the Investors and the Founders while executing Investment Agreements.

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