GREAT RISKS BUT GREATER REWARDS

*Avi Aggarwal**
*Chhavi Kiran***

INTRODUCTION

Contracts form the backbone of any business deal[1]. At the very heart of a venture capital is a complex contracting structure which has two limbs: a contract between the investors and the venture capitalist, and a contract between venture capital fund and a portfolio company[2]. It will be seen how venture capital market is inherently ridden of flaws like those of uncertainty, information asymmetry and agency costs in magnified forms[3], but special contractual tools are incorporated to effectively reduce these flaws. Primarily these contracts should be successful to minimize the impact of external economic factors.

Though there is no single ideal approach for organising the structure in the best possible manner and though the development path of any country cannot be replicated, the outcome of this path can be[4]. The difference will essentially lie due to factors such as their respective culture, economy, legal structure, and political framework.

The most vibrant venture capital markets in the world are China, US and Singapore. However, even with India having a completely different perspective and approach has become one of the fastest growing start-up eco-system in the world. For instance, major differences are unavailability of Limited partnership and draconian regulatory regime overseeing every aspect of the Venture Capital Fund (VCF) from registration to investment conditions has caused some troubles.

In this paper, we will look at Singapore's venture capital contractual structure in Part I followed by a very different contractual structure adopted in India to cross the same hurdles intrinsic to a venture capital contract in Part II, going further by pointing out the few gaps which can be filled to maximize the impact.

* The Author is a student of Masters in Law at University of Singapore.
** The Author is a Junior Research Fellow at Punjab University

[1] *Evolution of Decision and Control Rights in Venture Capital Contracts: An Empirical Analysis*, Carsten Bienz Norwegian School of Economics and Business Administration, Financial Markets Group and Centre for Financial Studies and Uwe Walz University Frankfurt and Center for Financial Studies (December 2006).

[2] PRANAY CHANDRAN, VENTURE CAPITAL CONTRACTING IN INDIA, (July 16, 2010), thesis submitted to WHU Master of Law and Business Program.

[3] *Id.*

[4] *Id.*

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PART I- SINGAPORE

CONTRACT BETWEEN VC AND INVESTORS

Nature of Contract

Venture capital firms are organized by way of a Limited Partnership (LP) which is an alternate form of business. It is pertinent to understand and delve into how such an engineering structure resolves manifold concerns of venture capital as also aid in its development.

From a legalistic point of view, the rationale behind incorporating a Limited Partnership can be explained by the following reasons, it is not a separate legal entity, and hence gives a wide scope of liberty and choice to incur unlimited liability for investors, especially for institutional investors[5]. They will also be able to shield themselves from the tax regime.

Furthermore, it is extremely favorable due to the flexibility it brings for parties by way of a partnership agreement wherein they can incorporate covenants and provisions depending on their nature of negotiations[6]. Such elasticity is important as venture capitalists (VC) need to employ restrictions to protect themselves from the high risk they get into, which is generally determined on the basis of fund size, compensation package and reputation of VC in market[7]. However, over use of contractual restrictions may become a cause for erosion of value of contract and thereby limit the flexibility to diversify risk or reduce agency costs[8]. It thus needs to be exercised sparingly for availing full benefit of such liberty.

Another unique characteristic to a LP is the relationship arising out of it between the VC (general partners) and the investors (limited partners). They share a principal-agent relationship wherein the principal takes steps to monitor and oversee the agent so as to give him least chances to act opportunistically. The limited liability of investors is definitely an added incentive for them to incorporate a LP, and for the VC's though they incur unlimited liability, it is off-set by the various protective measures they have at their rescue. Not only that, the reward is in the form of 20% share in profits against a mere 1% capital contribution from their side. Contract also enhances the attractiveness of venture capital by issuing convertible preferred stock, by which

[5] Report of the Study Team on Limited Partnerships, Summary of Recommendations on Limited Partnerships.

[6] Joseph A. McCahery & Erik P.M. Vermeulen, *Limited Partnership Reform in the United Kingdom: A Competitive, Venture Capital Oriented Business Form*, 5 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW.

[7] *Id.*

[8] *Id.*

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entrepreneurs can regain their control, when IPO is conducted[9].

On an important note, in a LP limited control is extended to investors and there is an automatic seizure of limited liability if they are found to participate in the management of LP or as may be referred as the VCF. This shields the VC's from any abuse of power and any sort of unruly behavior. However, since it is clear how the balance of power keeps shifting from parties, law has provided for a "safe harbor rule" to limit or even in some cases nullify the effect of such a strict provision which might be too unfavorable and repulsive for investors as it can lead to a very intrusive control in hands of VC's. For this purpose, this rule elucidates a negative list of actions not amounting to participating in management by which investor's will be in a position to play a more vital role in the functioning of the LP.

How does it maximize efficiency?

Moving on to the real essence of how exactly the contractual arrangement breaks into these uncertainties and makes venture capital investments an attractive proposition for both venture capitalists and investors with the same effect, we will examine three main sub-heads to prove the point.

- *Control*-Though on the face of it, the structure reflects an enormously discrepant division of control and presents an extreme version of disproportionate separation of control and ownership[10] where General Partner (Venture capitalist) holds almost complete control if not the entire decision making power, such control is necessitated in order to combat issues that arise by investing in early-stage companies and high risky ventures like agency costs, uncertainty and information asymmetry[11].
- *Compensation*-The compensation paid to the VC, majorly comprises of a 20% carried interest from the overall profit the VCF makes[12]. This is strictly to align its interest with investors and keep the VC motivated to lend its expertise and skill with utmost care and caution. Thus, it can safely be concluded that VC earns returns that are proportional to those earned by investors[13]. However, to off-set another agency problem, where VC might have the inducement to realise profitable investments before any unprofitable investments, there is a trend to delay the

[9] Ronald J. Gilson & David M. Schizer, *Understanding venture capital structure : A tax explanation for convertible preferred stock*, HEINONLINE 116 HARV. L. REV. 874 (2002-2003).

[10] Ronald J. Gilson, *Engineering Venture Capital Market: Lessons from the American Perspective*, HEINONLINE -55 STAN. L. REV. 1067 (2002-2003).
[11] *Id.*
[12] *Id.*
[13] *Id.*

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payment of VC until their performance can be evaluated and judged[14].

- *Mandatory distributions and fixed term*-It is understood that VC's and entrepreneurs are more likely to take riskier decisions than that would serve the investors[15]. For this, the organisation is structured such that VC's have a fixed term which assures that market at some time will assess their performance and make it more observable to showcase whether they preferred risk over expected returns[16]. Simply put, their reputation is at stake and hence they will not over exercise their discretion of using investor's money with recklessness. Such a fixed term ensures curtailing of any kind of opportunism they are liable to abuse. It functions like a contractually imposed takeover where VC has to leave it to the investors to decide whether they should continue or not[17]. In regard to mandatory distribution of proceeds, since they get a 2% management fee, they are more likely to make the effort to preserve the capital in the fund and consequently reinvest the proceeds of realised investments as long as is viable[18]. This also has a direct effect of reducing the downbeat consequences of being a part of a risky, volatile and dynamic industry such as venture capital.

CONTRACT BETWEEN VENTURE CAPITAL FUND AND ENTREPRENEURS

Nature of Contract

Such legal contracts between venture capital funds (VCF) and entrepreneurs essentially aim at the same goal of allocating risk, return, and ownership rights amongst them. Though, such distribution of rights depends on a number of factors like that of capability of the entrepreneur, the attractiveness of the portfolio company or the business plan, the stage of the company's development, negotiation skills of the parties[19] and also the overall state of the venture capital market.[20]

How does it maximize efficiency?

For this contract, essentially there are five techniques used to enhance efficacy of venture capital structures.

- *Staged financing*-The investor is given a right to discard the portfolio company after every milestone is met, which is set at certain events when performance and information can be

[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*

[19] WILLIAM L MEGGINSON, TOWARDS A GLOBAL MODEL OF VENTURE CAPITAL? (Dec 31, 2001).
[20] Paul and Josh Lerner, *Money Chasing Deals? The Impact of Fund Inflows on Private Equity Valuations, Gompers*, 55 JOURNAL OF FINANCIAL ECONOMICS (Feb 2000).

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judged and evaluated. This effectively deals with uncertainty problem of financing subsequent rounds. However, it is vital to point out how such a right to discard has its limits, and is balanced by the high cost it owes to the entrepreneur[21].

What it obviously aims to achieve is align interest of entrepreneur and VCF so as to provide a performance incentive to the portfolio company to meet the milestones and hence ensure their funding for subsequent rounds also. Further, it is not impossible for entrepreneurs to find new potential investors, however the contractual design is such that it makes it difficult and an unfavorable option. For instance, new investors owing to market knowledge will realize they are being solicited only because the previous ones were discontent with their performance[22]. Moreover, since the investor rights agreement gives VC a right of first refusal in refusing to finance succeeding rounds of investment, it is a huge hindrance to new investors[23].

Another agency cost that staged financing reduces is disallowing any opportunistic behavior by entrepreneur since they transfer control to VC which means they are unable to take decisions which might favor them but disfavor VCF[24]. Of course, the uncertainty it reduces is only which is within the realm and control of parties, however it increases the likelihood of expending more energy and effort on the part of entrepreneur[25].

Furthermore, it ministers in bridging the information gap between them since entrepreneur is naturally able to understand the technical nuances of its' business better than the VC, especially at the early-stage[26]. It is particularly difficult since there is no background knowledge of business or track record details to review the performance of the business. An added advantage is to bind the entrepreneur in telling the truth about the business plans as the right to abandon will become exercisable on failing to meet such pre-determined milestone plans[27].

Lastly, it also caters to the problem of VC's abusing their substantial power of discretion which they are likely to overstep, by way of negotiating a high price in the consecutive rounds of investments. There are in-built limitations/qualifications to it in the form of market forces which play the role of policing their exertion of discretion[28].This has been

[21] *Supra* note 10.
[22] *Id.*
[23] *Id.*

[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*

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termed as conservation of discretion principle and comes in handy to keep a check on VC's[29].

- *Allocation of control*-Control acts a lever to regulate and leash entrepreneur's responses based on uncertain and unspecified events. VCF's are given three types of controls in the form of-right to refuse funding in new rounds of investment if milestones are not met since in absence to such discretion to act in response to what it finds out, they would not exert that kind of resources and energy in the first place[30]. Secondly, VC's are given interim control by way of deciding the composition of board of directors, even to the extent of replacing the entrepreneur itself if it can justify the concerns[31]. These restrictions on the entrepreneur's role are in the form of negative covenants in their contract. However, it is obvious that such power comes with qualifications and is only a periodical control which constantly shifts between them, as regards to who is at a higher bargaining position at that time of the transactional relationship. Lastly, the VC by reserving such a right to terminate puts pressure on the entrepreneur to be honest with the viability of their project and demonstrate their belief, so as to signal to the VC that they are willing to accept the punishment in the form of complete shift of control from them.

The rationale behind having such perverse disparity in discretion is due to ever growing disparity of information which is created as the succeeding rounds complete as between the entrepreneur and the VC. Of course, this mechanism is the most effective tool to deal and diminish the fatal effects of uncertainties in the market.

- *Form of compensation*-In essence, a large chunk of compensation received by the entrepreneur is determined by the success and value created of a portfolio company. Thus, they have all the reasons to cooperate with VC in order to create maximum value from their investment. Their salary can be expanded and off-setted by the additional value generated, and thereby increase their own stake and control and issue stock options to members[32]. Such prototype of options used in the governance structure is tied to certain events where they can be triggered. This leads to greater risk for entrepreneurs if the company does not perform well since VC shares disproportionately in such events of downfall, but on the other hand, a proportionate sharing of profits in the event of a windfall[33].

[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.*

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- *Role of Exit*-The compulsion/necessity to exit from both the contracts stems from the problems inherent in both these relationships. In order to enable recycling its non-cash contributions from portfolio companies and thereby use cash contributions from such successful portfolio companies to invest in start-ups[34], there has to be an effective mechanism of exit which is provided for in the structure. From an entrepreneur's perspective, an exit allows them to get a hold of the control of their company again (eg. after IPO). On the other hand, it is clear how such recycling of investments will enable the investors to have a yardstick against which they can measure the performance of VCF and thus a successful exit will provide the necessary impetus required to persuade future potential investors in availing their expertise.
- *Reputation*-It is interesting to note how interaction of these contracts increases the efficiency of both contracts. The willingness of investors to transfer complete control on decisions of investment to VC, and passing of such discretion[35] is safeguarded by the real threat to VC reputation in the market that they are perpetually and naturally fear. A VCF is also liable to lose out on the best new entrepreneurs if it behaves opportunistically, as also it will fail to attract investors if it does not raise enough returns for them.

[34] *Id.*
[35] *Id.*

PART II- INDIA

INTRODUCTION TO VC MARKET AND REGULATORY REGIME

By the volume of transactions and investor funding in India, it can be safely said that the venture capital industry is well established, robust and vigorous[36]. There is empirical data and statistics to prove this, as provided by the Indian Venture Capital Association (IVCA) venture capital deals, increased by 28% to $15.2 billion, inching closer to 2007 peak levels of $17.1 billion. Overall deal volume in India grew by 14%, with early and growth stage deals accounting for 80% of total deals in 2014[37]. In 2016 it is expected to grow at an even faster pace and it is estimated to have an upward steep in the start-up activity [38]

The investment statistics should however be analyzed in the backdrop of only those funds which are registered and it is clear that not many VCF's have registered themselves and hence

[36] *Supra* note 2.
[37] BAIN & COMPANY, INDIA PRIVATE EQUITY REPORT (2015).
[38] Venture capital in India, Prequin funds in market statistics report (2014).

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there is minimal data on them[39]. Thus, the result of scrutinizing the VC market in India is testament to the fact that it is on the right path and has been successful to create a vibrant market, though there are loopholes which can be rectified which will be elucidated in the course of this paper.

The regulatory framework throws light on the entire attitude of the government towards venture capital and hence needs to be looked at before delving into the intricacies of the contractual tools. On reading the stringent rules under these laws, it will be easier to appreciate in which respects venture capital contracts are effective and which parts need an overhaul for maximization. Firstly, the main regulators who oversee the Venture Capital funds are SEBI, RBI and Income Tax Act, with SEBI being the nodal body for registering and regulating VC's. There are separate rules governing foreign[40] and domestic venture capital fund[41], but for the purpose of this paper we will compare Singapore's venture capital contracts only to the latter part.

[39] The Advisory Committee on Venture Capital, set up under Chairmanship of Dr. Ashok Lahiri (2003); www.sebi.gov.in.

[40] SEBI (Foreign Venture Capital Investors) Regulations, 2000.

[41] SEBI (Venture Capital funds) Amendment, 2000.

Before investigating into the efficacy of contracts, it will be useful to understand what qualifies as a Venture capital fund. There are three determinants to qualify which is, a dedicated pool of capital, raised in a manner provided for, and fulfillment of investment criteria. Registration is the primary step for VCF which is not found in Singapore. In India also though it does not invalidate a VCF due to non-registration, it exempts them from availing certain important benefits.[42]

CONTRACT BETWEEN INVESTORS AND VENTURE CAPITALISTS

As per the SEBI regulations, a VCF can be formed only in the form of a trust, company or body corporate. But by analyzing empirical data, a trust is formed for most of them for effectual functioning, thus we will look at other forms only restrictively and our focus will be on effectiveness of a trust.

As regards a contract between investors and VC's, the effect of incorporating a company is such that the objects clause should specify venture capital as its business, disallow invitation to public for subscribing shares, no member or officer should be involved in contentious issues in capital market and not be convicted of any offence to verify the

[42] *Supra* note 40.

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competency of such personnel's. Moreover, the funds raised cannot be used for any other purpose and the unit holders become the beneficiaries reducing the status of the company to have only fiduciary interest of the fund and therefore, no matter what form of VCF is created the essence is that of a Trust[43].

As regards a body corporate, it has to be set up under Centre or any state laws, carrying the business of venture capital, with almost similar other requirements as that mentioned for a company.

On forming a trust, a trust deed has to be entered into which has the effect of a Limited partnership agreement to the extent that it provides the much needed flexibility to the parties. The regulatory framework governing trust is stable and permits the parties to write its own standard of governance[44].

The deed has to be registered under the Registration Act, 1908 and again has the same requirements as enlisted for a company. Further, minute details of functioning of a trust explain how it has been an effective structure for VCF. We will thus examine the parties involved and their consecutive roles in the entire process.

The person who reposes confidence is the "author of the trust, the person who accepts the confidence is called the "trustee", the person for whose benefit the confidence is accepted is called the "beneficiary"[45]. For added clarification, the role played by parties is such that the investors are beneficiaries and the venture capitalists are their trustees[46] with the effect that beneficial interest lies with the investors and the legal interest lies with the managers. The trustee is in charge of the overall administration of the trust and receives a fee, which is an equivalent to a management fee under limited partnerships. They usually appoint an investment manager for managing the assets of the trust.

Moreover, the investor is called as the contributor who is required to make a capital commitment by way of entering into a commitment agreement.[47] It can be inferred that the liability a beneficiary undertakes here is negligible as compared to under Singapore structure wherein the investors is bound (though limited) up to 99% of its capital contribution.

Moving onto the effectiveness and viability of trust as compared to a company or body corporate, we can concur that it is a more

[43] VINOD KOTHARI & COMPANY, VENTURE CAPITAL FUND IN INDIA.
[44] NISHITH DESAI, GLOBAL, REGULATORY AND TAX DEVELOPMENTS IMPACTING INDIA FOCUSED FUNDS, (June 2015).
[45] *Id.*
[46] NIDHI BOTHRA,VINOD KOTHARI & COMPANY, VENTURE CAPITAL REGULATIONS- INDIA.
[47] *Supra* note 46.

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tax advantageous form[48]. Though the shares held by the trust or those that can be acquired are only limited to equity shares, signifies any preferential issue might lead to losing tax incentives[49]. Equity shares are preferred only due to the high returns attached to it as also the high possibility of having an active participation in the functioning of the company. Moreover, no obligation of fixed interest arises, since the dividend is solely dependent on the quantum of profit earned[50]. On the other hand, preference shares require a fixed amount of dividend irrespective of the company's performance[51].

Further, the requirements are negligible and compliance is not very cumbersome, replicating the effect of limited partnership again. Even for the purpose of winding up, trust is a simpler process. The distribution of returns on expiry of tenure of trust is more direct without many complications[52]. In a trust, there is no problem of repatriation of capital wherein there are losses as there is no hurdle of redemption of equity shares permitted only out of profits or newly issued shares[53].

One of the few shortcomings of a trust is that it is difficult to identify where beneficiaries are non-resident and for maximizing the effect, it should be altered to that extent. There are numerous investment restrictions stipulated under SEBI regulations which hamper the smooth and free functioning of a VCF. A minimum of Rs.5 lakhs investment is essential from any investor and shall be accepted only by employees, principal officer, directors of venture capital fund or employees of fund manager or Asset Management Company[54]. Not just that, it is also bound to invest minimum of Rs.5 crores in each of such funds set up by it[55]. This calls for an amendment since it has a huge negative impact on the attractiveness for start-ups who might not be able to raise so much money at the initial stage.

There are compliances with respect to winding up as well wherein the period of the fund cycle is matured it automatically terminates. However, by taking into account the interest of trustees and investors, the fund can even be wound up pre-mature by 75% majority resolution passed by them.

As regards obligations of VCF, it is instructed to not carry out any activity but that of venture capital, and is bound to make disclosures in respect to their investment

[48] ERNST AND YOUNG, PRIVATE EQUITY: BREAKING BORDERS.
[49] *Supra* note 44.
[50] GEO JOSEPH, THE STUDY OF VENTURE CAPITAL FINANCING-THE RIGHT PROCESS OF REACHING A VENTURE CAPITALIST AND FACTORS EFFECTING THE CAPITAL DECISIONS.
[51] *Id.*
[52] *Supra* note 44.
[53] *Id.*

[54] *Id.*
[55] *Supra* note 47.

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strategy and the life cycle. It receives units listed on any recognized stock exchange only after 3 years of its issuance. It is obligated to enter into a subscription agreement containing terms and conditions stipulating the proposed funds to be raised. A copy of this agreement and the money collected is placed before the Board. Lastly, VCF are also expected to maintain its books of accounts, records and documents for a period of 8 years[56]. It can be seen how stringently and closely VCF's are regulated in India which is the only aspect which makes it less feasible, even though the contractual structures and remedies for inherent flaws are battled with the same vigor and effect.

CONTRACT BETWEEN VCF AND THE PORTFOLIO COMPANY

Unlike the first contract (formation of VCF) wherein absence of a limited partnership in India has an absolute different approach, the second part of the contract in VC investments is structured in the same fashion and involves the same tools to dodge the same imperfections. Instead of dealing with abstract concepts of control and investment procedure here, we will examine real data to reflect how it effectively manages the difficulties in risky ventures in these startup firms.

[56] *Supra* note 47.

The substantial chunk of stake and ownership of the portfolio company is bestowed on VC's as against the entrepreneurs which deems to be a more desirable situation. In a survey conducted, it was found out that an estimate of VC stake in companies is 32.32% (average 30%)[57]. Since voting rights correspond to the ownership in the company, they are naturally not holders of majority voting rights[58]. But what VC's are seen to do is enlarge their ownership on account of non-fulfillment of certain milestones and performance targets[59]. Thus, it can be safely concluded that control exerted by parties by way of voting changes are based on pre- determined events.[60]

Similar to staged investment custom in Singapore, agreements typically lay the contours of the development which the fund evaluates, before agreeing to provide any further financing. But one deviation from Singapore law is the subsequent financing is of a diminutive value and terms are also not negotiated very efficiently to suit the needs of that phase or round. The time between each funding is seen to be a year or less than that which has a negative impact because of limited

[57] *Supra* note 2.
[58] *Id.*
[59] *Id.*
[60] Steven Kaplan and Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, NATIONAL BUREAU OF ECONOMIC RESEARCH, Working Paper 7660 (April 2000).

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time to scrutinize and analyze their performance.

Shares issued are almost always in form of convertible preference shares with infrequent issuance of equity shares, similar to Singapore. These shares also provide for pro rata participation in the remainder after liquidation and give the investors the rights to cumulative dividends[61].

With respect to liquidation which typically includes change in control, a merger or reorganization in addition to winding up rights, the contract provides the investor with a prioritized claim over the other[62]. The quantum of claim is always equal to the investment amount, to say the least.

Automatic conversion is the rule in such contracts so as to let the entrepreneurs regain the control they lose during such financing periods. The period of conversion is prescribed in the instrument of issue of shares. Like Singapore, IPO plays a vital role as an exit mechanism acting as a triggering event for automatic conversion. Of course there are other events like that of a sale or of a pre-determined milestone which propel the conversion rights in motion. Such conversion depends a lot on negotiation between the parties since the entrepreneur runs the risk of losing his ownership and the business idea to the VC's[63].

Investors under this contract also reserve the right to call for buying back their shares and issuing options[64]. Some of them are allowed to be exercised only after expiry of specified period and others might be used as an offensive tactic to a breach of any clause. Though the investors have a strong board representation, they lack a majority of seats and are mostly below 50% of seats, as inferred from sample surveys. Such a number of seats at the board indicate the percentage of stakes they hold in the company which is consequently construed to be less as compared to those of VC's[65].

Investors hold pre-emptive rights and specifically a tag-along right wherein the investor can sell or transfer its shares with the selling shareholder to a third party on the same terms and conditions[66]. Most of them are also found to hold right of first refusal options, and many held drag-along rights whereby they can require the other shareholders to sell shares along with the investor if he so requires in order facilitating an exit through a third party sale[67]. As can be seen, this is also a protective tool

[61] *Supra* note 2.
[62] *Id.*
[63] *Supra* note 50.
[64] *Id.*
[65] *Id.*
[66] *Id.*
[67] *Id.*

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against external economic mishaps that may occur and cause losses to them.

Investors also have affirmative voting rights on issues that may have a substantial impact on them. To give effect to such a right, it is usually stipulated to necessitate their presence at the time of voting and passing resolutions or any other actions taken[68].

The agreement also enlists the detailed issues which will attract such voting rights in their favor. This entails, as in Singapore a chance to oversee and overlook the functioning of the portfolio company. Contracts provide the investors with elaborate information rights for the purpose for accounts and financial statements of the company[69]. Specifically, investors have extensive and an intrusive role to play in appointing auditors for the company, however they are required to consult their VC's.

Such features of contract in India provide for the same mechanism to effectuate a more balanced arrangement between VCF and portfolio companies, as in Singapore except that is more regulated. Thus, we look at the shortcomings which need to be overcome for India to reach where Singapore, China and US are today.

[68] *Id.*
[69] *Id.*

Tools to maximize efficiency

As seen above, India's venture capital needs reduction in regulations. This is so because it is clear how investments can be best nurtured in conditions where there is a flexible market with ample opportunities. Too many restrictions end up confusing the potential investors and dampen their spirit at the entry stage itself[70]. Although it already has the basic infrastructure for profitable investment opportunities as well as a well furbished stock market[71].Of course this has to be exercised in a phased manner.

Furthermore, initiatives in India have been primarily taken by public sector. Thus, the expectations like those of managerial support and entrepreneurial expertise is difficult to be fulfilled by them since their culture is ridden by rigid procedures and strict accountability[72]. Moreover, since the VCF is illiquid in first 1-2 years, it will take time to exhibit capital appreciation for financial reasons. The returns could be given to investors only where it has built a diversified portfolio since the rate of success will be rather dismal and low at the beginning. The management of the public sector

[70] Swati Deva, *Foreign Venture Capital Investment: The Indian Experience*, HEINONLINE: 42 INT'L LAW. 177 2008.
[71] *Id.*
[72] Sudip Bhattacharyya, *Venture Capital Financing*, ECONOMIC AND POLITICAL WEEKLY, Vol. 24, No. 47 (Nov. 25, 1989).

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company ends up being caught up for losses and thus, effecting the motivation for venture capital financing tools. VCF can administer a lot better if private parties took initiative, or the public sector VCF becomes more independent and authoritative[73]. Though it is now changing and we have one of the most oldest and successful conglomerates; Tata's who have ventured into investing in early stage companies and giving the necessary impetus for them to grow by lending their well established reputation.

The rules are such that the law provides for the industries a VCF cannot invest in thereby limiting the options it has. For instance, it cannot deal in businesses of real estate, non-banking financial services, Gold financing and activities not permitted under industrial policy of Government of India. No other country provides for such a negative list of investments restricting VCF.[74]

Further, VC's seldom have a majority voting power, even in early stage companies. This is primarily due to the provisions of the Indian Companies Act whereby a shareholder's voting right can only be in proportion to his share of the paid-up equity capital of the company[75]. It is extremely important for an effective contractual structure to provide enough control to the VC's. The biggest loophole is in the form of lack of definition of control that they hold in the portfolio company. However, again the relationship between VC's and portfolio companies have transformed from "us" to "them". All the VC's have to do is demonstrate their commitment to entrepreneurs by cleverly aligning their interests to theirs, and exerting enough time to win over their loyalty and trust[76].

For the purpose of formation of VCF itself, it is ridiculous to ignore the perfect suitability of a LP. Thus, law makers should legislate on allowing a limited partnership form. It should do away with the strict requirements associated with registration with SEBI. Moreover, enhance flexibility in risk sharing and compensation payments amongst investors[77].

Further going into the intricacies of the contractual structure, the conditions pursuant to which a company can issue equity shares with differential voting rights in India are unlikely to be fulfilled by start-ups[78]. For this, there has to be steps taken to make it more start-up friendly. However, it is not as bad as it reads; a large

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[73] *Id.*

[74] *Supra* note 40.

[75] Companies Act, 2013, § 87(1)(b), (India).

[76] Shailendra J. Singh, Ashok Dylan Jadeja & Shashank Singh, *Venture Investing in India? Think Twice*, THE JOURNAL OF PRIVATE EQUITY, Vol. 8, No. 4 (Fall 2005).

[77] *Supra* note 40.

[78] One such condition is distributable profits for last 3 years; see The Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001.

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stake combined with other contractual clauses covers the corners for the VC to exercise considerable control if not sufficient control.

In terms of investments made by investors, it needs to be made more attractive upon achieving the required targets[79], which does not happen since the fund cycle is a short period and hence they end up remaining within the early stage making it riskier for an investor. Even in regard to compulsory conversion after a fixed term, due to strict requirements of foreign exchange regulations in India[80], it does not represent a valid option to the entrepreneur as the terms are extremely long.

Overall, there are extremely onerous burdens imposed on the entrepreneur and has a trend of heavily being inclined in favor of the investor. However, as it has been emphasized throughout, due to the very nature of venture capital financing the contract must deal with extreme forms of uncertainty, informational asymmetry and agency costs. Naturally, such uncertainties have had a magnified impact in context of an emerging economy like India where markets and industries are still developing. Also aspects like the regulatory environment and corporate governance standards being relatively lower than more mature economies. Further cultural aspects like a tendency towards closely held, family controlled companies may also contribute to some extent.

CONCLUSION

Though there is no magic potion for a perfect maximization technique, there are a few ingredients which are known for improvement[81].We know India is growing significantly since the last decade, particularly in the IT and biotechnology sectors, and there is close synergy between Indian companies in these sectors and their counterparts in the Silicon Valley. Simultaneously, the Indian regulatory and taxation regime for venture capital has also witnessed rapid development to create an enabling regime for fostering innovation through venture financing[82]

On final review, the author wants to conclude that picking up solutions directly from any other judicial system (in this case Singapore) will be an effort in vain. The amendments should be such that are not only good in theory but functional in an economy like India and hence replicating any form from other countries is not an ideal approach. This

[79] *Supra* note 9.
[80] Press Note dated 30 April 2007 in supersession of the earlier Press Note dated 31 July 1997 and, RBI Circular, dated June8 2007, A.P. (DIR Series) Circular No.73.

[81] R&A ASSOCIATES, PRIVATE EQUITY FUNDS: A CASE STUDY
[82] UMAKANTH VAROTTIL, INDIAN BUSINESS LAW NOTES..

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obviates the need of a complete overhaul of the present system but mandates small steps towards a more attractive venture capital industry.

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