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Understanding Term Sheets and Shareholders' Agreements

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UNDERSTANDING TERM SHEETS AND SHAREHOLDERS' AGREEMENTS

Term sheets and shareholders' agreements play a pivotal role in today's business environment, wherein private arrangements between shareholders have exponentially increased given the boost and impetus to private investments by venture capitalists, private equity funds and other private players. We have hereunder discussed the key facets of term sheets and shareholders' agreements.

A. TERM SHEET

The key commercial terms and conditions based on which an investment shall be made in a company and based on which the *inter se* relationship between the shareholders of the company shall be regulated are initially spelled out in what is called the term sheet.

The term sheet is a document entered into by and between the parties who wish to enter into an agreement prior to executing the definitive agreement where the provisions of the term sheet are fleshed out. The term sheet is thus the primary document basis on which the parties negotiate the terms and conditions they want to incorporate in the definitive agreement.

A term sheet can either be a binding or a non-binding document, which can be decided by the parties and set out in the term sheet.

B. SHAREHOLDERS' AGREEMENT

The Articles of Association ("**Articles**") of a company is the key document which sets out the relationship between the company and all the shareholders, and also sets out the relationship between the shareholders *inter se*. The Articles becomes binding on all the shareholders of the company whether such shareholder was a member at the time the Articles was signed or becomes a shareholder later.

Section 10(1) of the Companies Act, 2013 ("**Companies Act**") sets out that the registered Articles of a company binds the company and the members to the same extent as if they respectively had been signed by the company and each member and member.

"10(1). Subject to the provisions of this Act, the memorandum and articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed by the company and by each member, and contained covenants on its and his part to observe all the provisions of the memorandum and of the articles."

Although the Articles of the company is the key document setting out the *inter se* relationship between the shareholders of the company, certain segments of the shareholders

of the company enter into private agreements among themselves, through a Shareholders' Agreement ("**SHA**").

A SHA is an agreement entered into by and between some or all of the shareholders of a company with the key purpose of regulating the relationship between the shareholders of the company. In today's business environment SHAs are a very common and prevalent form of document entered into for governing the relationship *inter se* amongst the shareholders entering into such SHA and also for setting out the rights, duties and obligations of the shareholders.

There may be various circumstances wherein SHAs are entered into, *viz.*, for setting out the relationship between the joint venture parties and drawing up their rights and obligations while setting up a joint venture company, in case of entering into any strategic alliance arrangements, in case of venture capital/ private equity/ foreign portfolio investments, and so on.

We have discussed the key facets of a SHA and the key heads of terms which are generally included in a standard SHA.

THE KEY HEADS OF TERMS INCLUDED IN A STANDARD SHA

SHAs are entered into by and between the shareholders of a company for setting out the specific rights and imposing restrictions and obligations on the shareholders, therefore, the SHA can be tailor made to suit the particular legal and commercial requirement in any given factual matrix. However, the key terms of heads which are included in a standard SHA is as under:

(1) **Parties and Recitals**

The parties shall mean the shareholders/ parties entering into the SHA. The recitals would record the background and the purpose of executing the SHA, *viz.* governing the inter-se rights amongst the shareholders and the management of the company.

(2) **Definitions and Interpretation**

The definitions and interpretation head to define certain key terms and setting out the manner in which the SHA shall be interpreted.

(3) **Representations and Warranties**

The SHA is entered into by and between the shareholders based on certain representations and warranties, which forms the basis of the parties entering into the arrangement. Such representations and warranties include the requisite corporate authorizations, time frame, etc.

(4) **Share Capital Ratio**

This would reflect the ratio of the shares in the company held by the shareholders entering into the SHA as against the total paid up share capital of the company.

(5) **Further Financing of the Company and further Issue of Shares**

This clause would cover the modality of raising further funds for the company, viz. debt, equity or other sources. The Board could unanimously decide such mode. The clause could also provide the extent (whether pro-rata or otherwise) that each shareholder would be liable to provide funds or provide security for raising funds. The clause could also provide for the initial offer for the issue of further shares to be on a pro-rata basis amongst the parties.

(6) **Management of the Company**

This head would include the following provisions setting out how they will be regulated:

- (a) Board of Directors
- (b) Meetings of Board of Directors
- (c) Shareholders Meetings
- (d) Auditors
- (e) Dividend
- (f) Business Policy and Management
- (g) Management Personnel
- (h) Exercise of Voting Rights

(7) **Shareholders Rights and Obligations**

The following provisions are covered under this head:

- (a) Restrictions on transfer of shares, if any.
- (b) Information rights of shareholders such as right to financial reports, right to inspect the premises, assets, etc.

(8) **Restrictions**

Although various specific restrictions can be included in the SHA, it is pertinent to note here that, restrictions are enforceable against the company only if such restrictions are included in the Articles of the company.

Various courts have taken the view that with respect to transferability of shares, the restrictions set out in the SHA shall be enforceable only if such restrictions are included

in the Articles of the company. The Supreme Court in the matter of V. B. Rangaraj v. V. B. Gopalkrishna¹ has also taken the aforementioned view and is the most important case on this matter.

In IL&FS Trust Company Limited v. Birla Perucchini Limited², the court took the view that the decision of the Supreme Court in the Rangaraj case was also applicable to conflicts between the Articles and SHA not involving transfer of shares.

However, if the restriction is included in the Articles of the company then such restriction can be incorporated in the SHA and such restriction shall be enforceable against the parties to the SHA. While there can be several variations of restrictions, typical restrictions include:

- (a) Right of First Refusal
 - The selling shareholder shall be required to offer his shares to other shareholders prior to offering such shares to any third party.
 - Price to be agreed mutually or by a pre-identified valuer.
 - If this right is triggered by an offer received from a third party, then the right of first refusal should be on the same terms as the third party offer.
- (b) Co-Sale Option (Tag-along)
 - In case of a shareholder selling his shares to a third party, the other shareholders have a right to sell their shares in the company with the selling shareholders on the same terms.
 - If all the shares proposed to be sold are not able to be sold, then each shareholder would sell a pro-rata portion of the shares that can be sold.
- (c) Drag-Along Rights
 - Right of a majority/ dominant shareholder to force other shareholders to sell their share along with the shares of the selling shareholders in order to sell a majority/ entire share capital of the Company. This provision, however, may not always be in the interests of a minority partner.
- (d) Lock- in

¹ (1992) 1 SCC 160

² (2004) 121 Comp Cas 335

- The shares held by certain or all parties could be locked in for a limited period of time.

(9) **Other Ancillary Documents**

This clause shall refer to the various documents, which may be required to be executed by the parties pursuant to the shareholders agreement, if any, such as the put option agreement, etc.

(10) **Dispute resolution**

This head shall set out the mode of dispute resolution between the parties to the SHA if a dispute so occurs amongst them. The parties have the freedom to choose the dispute resolution that best suits their legal and commercial interests, viz.:

- (a) Mutual consultation between the disputing parties followed by arbitration;
- (b) Mediation followed by arbitration;
- (c) Arbitration;
- (d) Court litigation

The parties shall have the freedom to choose the manner in which the arbitration is proposed to be conducted, whether international institutional arbitration³ or domestic *ad hoc* arbitration.

(11) **Termination**

Various grounds such as insolvency, liquidation, uncured breach etc. could be provided in this respect. Further, a consequence of breach could be provided, such as purchase of the shares of the breaching party by the non-breaching party at a discount; or the purchase of the shares of the non-breaching party by the breaching party at a premium.

(12) **Miscellaneous Provisions**

This head would typical include provisions such as severability, waiver, indemnification, assignment, governing law, jurisdiction, relationship between parties, severability, entire agreement, specific performance, taxes, costs and notices.

³ International institutional arbitration includes arbitration before the Singapore International Arbitration Centre, London Court of International Arbitration, International Chamber of Commerce, Dubai International Arbitration Centre, etc.