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Avinash Kumar has completed his Ph.D. in International Investment Law from the Dept. of Law & Governance, Central University of South Bihar. His research work is on "International Investment Agreement and State's right to regulate Foreign Investment." He qualified UGC-NET and has been selected for the prestigious ICSSR Doctoral Fellowship.He is an alumnus of the Faculty of Law, University of Delhi. Formerly he has been elected as Students Union President of Law Centre-1, University of Delhi.Moreover, he completed his LL.M. from the University of Delhi (2014-16), dissertation on "Cross-border Merger & Acquisition"; LL.B. from the University of Delhi (2011-14), and B.A. (Hons.) from Maharaja Agrasen College, University of Delhi. He has also obtained P.G. Diploma in IPR from the Indian Society of International Law, New Delhi.He has qualified UGC – NET examination and has been awarded ICSSR – Doctoral Fellowship. He has published six-plus articles and presented 9 plus papers in national and international seminars/conferences. He participated in several workshops on research methodology and teaching and learning.

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CORPORATE INVESTMENTS: A HINDSIGHT OR A FORESIGHT!?

Authored by- Kritika Shrivastava

Abstract

One of the most recent developments that the nation has witnessed in the corporate investment trends is Venture Capital and Private Equity. Investments in venture capital and private equity **("VCPE")** have emerged as a viable source of corporate finance, and they are a crucial facet of India's growing narrative. The importance of VCPE investments in India in terms of fostering business development, innovation, and prosperity cannot be understated. India evolved through numerous stages in the increasing tendencies of VCPE investments until attaining its current degree of prominence, owing to an enabling legislative framework and positive macroeconomic determinants. To meet the government's growth plans, VCPE investments will have to quadruple at the existing rate of development of equities, bonds, commercial lending and borrowings, and bank credit pools. The author in this article provides the nature and scope of the investments and analyses the factors that led to the growth of corporate investments.

Keywords: Private Equity, Venture Capital, investment, company.

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Introduction

The most crucial element in any entrepreneurship is the 'Finance'. Lately, it has been observed that both private equity and particularly venture capital[1] has become extremely significant for a growing number of economies not just domestically but also globally. The major goal of private equity and venture capital is to aid the companies in accomplishing growth through providing finance, strategic advice and germane information at grave stages and phases of their development.

Financial investors provide equity money to unlisted firms with substantial potential for development through private equity. Private equity financing encompasses not just the funds required to launch a company, but also money needed later in its life cycle. A subcategory of private equity, venture capital alludes to equity investments made for the start-up, early development, or evolution of a company. It places a greater focus on entrepreneurial activities than on established companies. Various phases of investment are referred to by the term private equity and venture capital.[2]

Alternate Investment Funds (AIF) includes private equity investment funds, venture capital funds, and other types of funds. The term AIF is characterised as any fund created or integrated in India that accumulates funds from high-net-worth individuals, whether Indian or foreign, for making an investment in compliance with investment policy for the financial advantage of its investors, according to the SEBI (Alternative Investment Funds) Regulations, 2012 as amended on March 6, 2017.[3]

Though the terms are quite used interchangeably, it is very different in its being. The research article provides a detailed background on the nature and scope of VCPE in India followed by its implications. Further, the article also surfaces on the legal dimensions and implications relating to VCPE in India.

[1] Naqi, S.A., and S. Hettihewa. "Venture Capital or Private Equity? The Asian Experience." Business Horizons, Vol. 50, No. 4 (2007), pp. 335-344

[2] Tripathi, S. "Trends and Patterns in Venture Capital/Private Equity in India: A Review." IUP Journal of Management Research, Vol. 14, No. 2 (2015), pp. 39-51.

[3] SEBI (Alternative Investment Funds) Regulations 2012, s 2(1)(b).

Background And Analysis

PRIVATE EQUITY

As is it known by all that the term ‘Private Equity’ does not have a universally accepted definition but is regarded as the rebranding of leveraged – buyout firms. The PE firm also sometimes called as the ‘financial buyers. The funds for Private Equity usually come from sources such as pension funds, endowments, institutional investors, individuals with high net worth and investing companies.[4] The investors get their capital within a short period and with a much higher return.

There are four major stages involved in the investment of Private Equity[5]:

i. Seed - Stage Investment: This stage involves that investment made for marker research and development. Herein, the investment is only for the purpose of establishing a business idea.

ii. Early – Stage Investment: In this stage, the companies initiate with their operational activities with the help of the investments made and before engaging in the activity of commercial sales.

iii. Formative – Stage Investment: Herein, the capital is invested by the investor in initiating or scaling up the operations of the company.

iv. Later – Stage Investment: Herein, the capital is invested with the objective of expanding the business and the investment is made to grow the business before it goes public.

There are enumerative legislative and regulatory provisions that discusses about the relevance private equity holds in India. The primary statutes involved includes The Companies Act of 2013 regulates the terms and processes for the issuing and transfer of shares and other securities, as well as governance measures for boards of directors and shareholders. The Income Tax Act of 1961 legislates all direct taxation-related facets of private equity transactions, such as applicable taxes on income derived, tax benefits, tax on capital gains, tax exemptions, and tools to identify the rate of shares and other securities. It is pertinent to note that this legislation should be read in conjunction with the relevant double taxation avoidance treaty or agreement if there is any. Further, The FEMA empowers the Reserve Bank of India **(“RBI”)** to regulate and supervise all foreign investments into Indian target enterprises, operating under or pursuant to authorities granted to it under the RBI Act,

[4] Siddharth Shah, ‘Private equity investments in India: a Legal and Structural Overview. International Financial Review’.

[5] Anuraag Pillai, ‘Private Equity Investment and its Regulation’ <SEBI (Alternative Investment Funds) Regulations 2012, s 2(1)(b) <https://taxguru.in/corporate-law/private-equity-investment-regulation.html#_ftn5> accessed 6 May 2022.

1934 and related banking laws and regulations.

The Department for Promotion of Industry and Internal Trade of the government of India issues and amends the Consolidated Foreign Direct Investment **("FDI")** Policy from time to time, as well as diverse rules, regulations, master circulars, guidelines and other entrusted provisions authorised by either government of India or the RBI, particularly pertaining to FEMA, specifically regulating FDI into India. The SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018, the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011, and other regulations issued by India's securities markets regulator, the Securities and Exchange Board of India (SEBI), regulate and monitor private equity investments into a listed entity. The SEBI (Alternative Investment Funds) Regulations of 2012 are a set of regulations that govern alternative investment funds. All labour laws, environmental laws, and rules providing for essential enrolments with different government authorities, subject to the industry or field in which the target conducts its business and operations, are ordinarily meaningful to the due diligence processes and evaluations typically performed in correlation with and prior to the concluding of private equity transactions.

VENTURE CAPITAL

A venture capital fund (VCF) invests in innovative and promising businesses that are often knowledge-based, have a highly risky profile, but forecasts long-term development and better returns.

Venture capital funds are not small investors since they not only invest in a company's stock but also aid in its administration and operation[6] by lending their skills to the firm. These firms are unable to generate money via traditional forms of financing because they lack a significant proven record to entice capital investment, do not have physical assets to function as security against a loan, and have relatively long growing periods.

Venture Capital is usually moulded in the form of a Company, Trust or a body corporate. Similar to that of Private Equity, even in Venture Capital banks, financial institutions, corporations, pension funds, individuals with high net worth invests their capital.

In India, Venture Capital can be classified on the basis of its promoters in the following manner:

[6] Komala, G. "A Paradigm Shift In Indian Venture Capital Industry." International Journal of Business and Management Research, Vol. 4, No. 10 (2014), pp. 281-286.

 ISSN: 2582-6433

i. Venture Capital Funds endorsed by the Central government-controlled development financial institutions such as TDICI, by ICICI[7], Risk capital and Technology Finance Corporation Limited (RCTFC) through the Industrial Finance Corporation of India (IFCI) and Risk Capital Fund by means of IDBI[8].

ii. It is sponsored by the state government-controlled development finance institutions such as Andhra Pradesh Venture Capital Limited (APVCL) through Andhra Pradesh State Finance Corporation (APSFC)[9] and Gujarat Venture Finance Company Limited (GVCFL) by means of Gujarat Industrial Investment Corporation (GIIC)[10]

iii. Also, endorsed by Public Sector banks such as Canfina and SBI-Cap.

iv. Venture Capital Funds endorsed by the foreign banks or private sector companies and financial institutions such as Indus Venture Fund[11] and Grindlay's India Development Fund[12].

The many forms of venture capital are divided according to how they are used at different phases of a firm. Early-stage funding, growth financing, and acquisition/buyout financing are the three main forms of venture capital. The venture capital financing process is completed in six steps, each of which corresponds to various stages of a company progress:

i. Seed money: It is low-cost capital used to test and develop innovative ideas.

ii. Start-up: New businesses that require capital for marketing and product development.

iii. First-Round: Manufacturing and initial sales investment.

iv. Second-Round: Operational money provided to early-stage businesses that are selling items but are not profitable.

v. Third-round financing: It is often referred to as mezzanine financing and the money is used to grow a potentially profitable business.

vi. The fourth round: It is often referred to as bridge funding, is suggested to fund the "going public" process.

Legal regimes that work around Venture Capital involves The SEBI Act of 1992 and the SEBI

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[7] ICICI Venture <https://www.iciciventure.com/about-us/brief-history-of-icici-venture#:~:text=ICICI%20Venture%20was%20founded%20in,and%20Unit%20Trust%20of%20India.> (accessed 1 May 2022).
[8] IFCI Limited <https://www.ifciltd.com/?q=en/content/ifci-venture-capital-fund-ltd> (accessed 5 May 2022).
[9] Andhra Pradesh State Finance Corporation < https://esfc.ap.gov.in/ > (accessed 5 May 2022).
[10] Gujarat Venture Finance Company Limited <https://gvfl.com/ >(accessed 5 May 2022).
[11] Indus Venture Fund <http://www.indusventure.com/> (accessed 5 May 2022).
[12] Grindlay's India Development Fund < https://www.valueresearchonline.com/funds/1593/grindlays-government-securities-fund-investment-plan-institutional/ > (accessed 5 May 2022).

(Venture Capital Fund) Regulations of 1996 control venture capital in India. As per this, every firm or trust that want to operate a Venture Capital Fund must obtain a certificate from SEBI. Foreign Venture Capital Investors (FVCI) are not required to be registered under the FVCI regulations mandatorily. Securities Contract (Regulation) Act, 1956, SEBI (Substantial Acquisition of Shares & Takeover) Regulations, 1997, and SEBI (Disclosure of Investor Protection) Guidelines, 2000 are also applicable to venture capital funds and foreign venture capital investors.

Private equity and venture capital help businesses to expand and develop, as well as support businesses that would otherwise struggle to expand or exist. Thousands of businesses benefit from it, and it enables for the creation of new technology and applications.[13] Because of the industry's aim to increase core performance of the company, private equity and venture capital investment might be one of the most powerful engines pushing overall corporate optimum efficiency.

Private equity and venture finance have helped companies become big brands. Institutional investors are the significant beneficiaries from private equity and venture capital firms' profits.

Key Documentation In Vcpe

The two most crucial documents that are required for carrying any of these transactions are Shareholders Agreement **(“SHA”)** and Shareholders Subscription Agreement **(“SSA”)**. Based on the nature and other terms of the contract, the parties may agree on additional documents such as an escrow arrangement to protect funds, shares, cash, or assets, or employment agreement with Investor-specified terms binding its promoters.

i. Shareholders Agreement: A Shareholder's Agreement is a contract between a company's shareholders and are specially structured to grant particular rights and impose specified constraints above and beyond what the Companies Act of 2013 directs. Under this agreement, transfer restrictions should be given due attention.A PE investor often prefers the promoters of an Indian company to remain in the organization till the time investor has invested, and sets constraints on the promoters' ability to sell their shares. Each of these limits should be evaluated in the context of a public or private corporation. Shares in a public firm can be freely transferred but private business must place limits (but not total prohibitions) on its share transfer.

The most important restrictions are Promotor Lock-In, Right of First Offer (RoFo)/Right of

[13] Rajan, A.T., and A. Deshmukh. “An Analysis of Venture Capital and Private Equity Investments and Exits during 2004–08.” Indian Venture Capital and Private Equity Report, 2009.

 ISSN: 2582-6433

First Refusal (RoFR) and Tag-Along or Co-Sale Rights. Further, downside protection plays a significant role in ensuring protection when things can go wrong with the investee company. This generally includes Bonus Issue, Issuance at lowest legal price, Adjustable Conversion Prices / Conversion Formulas and Veto on Future Issuances. Lastly, and most significantly for the investor is the Exit Options to be able to divest its holdings and exit in the most lucrative and hasty way. These options include an Initial Public Offering (IPO), ADR / GDR Listing, Buyback / Put Options, Strategic sale and Drag Along Rights.

ii. Shareholders Subscription Agreement: A Share Subscription Agreement (SSA) governs the purchase of new business shares by a group of current or new shareholders. When a company raises money from investors in exchange for shares, the shares are referred to be "subscribed" by the investors. The value, share value, amount of securities, significant dates, and capitalization table (shareholding) facts are normally included in the SSA. SSA also provides a detailed background on Representations, Warranties and Indemnities.

Key Segments Inviting Vc/Pe Investments In India

PE/VC firms pay utmost attention to India in emerging trends with an intent to invest. The lase decade that witnessed a remarkable advanced growth of investments in the nation were in the following sectors:

i. Infrastructure –Infrastructure is the most common sector where the investors have lined up exploring the potential. Financial powerhouses such as Citigroup and Blackstone have played a crucial role in supporting this. This involves big bets on road sectors as well either through partner developers directly or through bidding jointly for the highway projects or pick up stake in the infrastructure firms.

ii. Energy - As a result of the massive rise in energy demands to sustain the skyrocketing industries, this sector has experienced a significant surge in private equity investments.

iii. Clean Technology - The notion of clean technology has created a need in this industry as a result of global climate changes and the limited nature of natural assets. India's need for comparable technology to address its growing problems such as pollution and fresh water scarcity has rendered it one of the most attractive places for clean technology investment.

 ISSN: 2582-6433

Latest Trends

In the recent times, especially after 2020 i.e., the pandemic period has extensively influenced investment decisions of PE/VC firms in the country. At the stage of recovery, India has been seen as one of the leading markets for fresh investments across the globe. The reasons for such an increasement can be due to the contraction of GDP in India and is now currently regrowing again. Further, the rebound of Indian Stock Markets and initiatives such as 'AtmaNirbhar Bharat/Make in India' has proclaimed its way to self-sufficiency. Moreover, local manufacturers now have a bigger opportunity in the market after the ban of import of certain goods and services in the country.[14]Currently, the sectors booming and attracting investments include:

i. EdTech – The harmonious blend of technology and education is not unknown. This blend is growing at a rapid pace giving the learners the convenience to learn from their homes at their own timings. Such growth has highly attracted investors to invest in edtech companies such as Byjus, Upgrad, etc.

ii. Healthcare and Insurance – After the pandemic breakdown, the importance of healthcare and insurance sectors remains undisputed. There has been a massive spike in demand for medical services and investments have been increased in the medicine and healthcare sector.

iii. Fintech – As the world is moving towards globalisation with technological assistance, fintech sectors are diverting the reliance of population on physical banking services. The services like Buy Now, Pay Later, zero maintenance digital banking have guaranteed customers not only with their privacy protection but also with high return cash rewards. Such examples include, Paytm, Simpl and Phonepay.

Other crucial sectors that have seen farfetched investments includes agritech, logistics, E-Commerce, gaming, mobility, foodtech, crypto and SaaS (Software as a Service).

[14] Tomorrow Makers, Popular Sectors To Invest in with The Private Equity Industry Booming in India <https://www.tomorrowmakers.com/other-investments/popular-sectors-invest-private-equity-industry-booming-india-article> accessed 4 May 2022.

 ISSN: 2582-6433

Conclusion

Almost every venture capital and private equity behemoth has either established an on-the-ground presence in India or raised large India-focused funds in the recent years. In India, private equity and venture capital companies play a vital role in determining the nation's economic progress through encouraging innovation and entrepreneurship.[15] Various variables in the nation, including as GDP, FDI inflows, interest rates, and stock market accessibility, have all added to India's large increase in VC/PE investments during the last two decades. In addition, regulatory rules have evolved and also been altered throughout time, aided by good governance, different government programs, and a conducive exit scenario.

Given the economy's expansion, many investors have a larger tolerance for risk for India than the typical. As a result, individuals may feel that the chance is too good to pass up and instead invest in common stocks. Furthermore, regardless of the fact that leveraged buyout activity remains low in India due to another set of restrictions prohibiting banks from financing money for stock acquisitions, PE/VC activity in India has reached new highs.

Despite the fact that the aforementioned rules can be a barrier for PE/VC investors on some occasions, India's legal framework, regulatory system, corporate governance levels, and market position all compare favourably to many other emerging countries. And, with unprecedented amounts of cash on board, PE/VC investors are eager to invest it in sectors that deliver them high returns.

[15] Kumari, V.J. "An Analysis of Trends of Venture Capital and Private Equity Investments in India." Indian Journal of Economics and Business, Vol. 12, No. 1 (2013), pp. 73-81.