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MAPPING PRIVATE EQUITY DISTRIBUTION AMONG SHAREHOLDERS: A LEGAL ANALYSIS UNDER THE COMPANIES ACT OF 2013

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ABSTRACT

In recent times, private equity (PE) has emerged as a prominent source of funding for enterprises. Given the growing dependence of private enterprises on the private equity market for financial support, it is imperative to comprehend the ramifications of private equity distribution among shareholders in accordance with the Companies Act of 2013. This research scrutinizes the provisions delineated in the 2013 Companies Act pertaining to the dissemination of private equity and provides an exposition of the prevailing status of private equity distribution in India. Furthermore, the study delves into the legal risks associated with private equity investments and their potential impact on shareholders. The concluding remarks of the inquiry contemplate the potential influence of private equity investments on shareholder value.

INTRODUCTION

Private equity (PE) distribution is the method by which profits are divided among investors in a PE fund. The Companies Act is a set of laws governing the formation, operation, and dissolution of companies in a given jurisdiction. Understanding the relationship between PE distribution and the Companies Act is crucial as PE funds are commonly structured as companies and thus subject to the provisions of the Companies Act.

Numerous studies have investigated the impact of the Companies Act on PE distribution. For instance, a study published in the Journal of Corporate Finance in 2010 examined the distribution provisions of the Companies Act in the United Kingdom and found that they could significantly influence the structure of PE funds. Specifically, the study revealed that the Companies Act's provisions on distributions, such as the payment of dividends or profits to shareholders, could restrict the ability of PE funds to distribute profits to investors.

Private equity is a form of investment capital often provided to privately held, non-publicly listed companies. Private equity investments are typically made by private equity firms, which pool money from institutional and individual investors to create a fund used for investing in private companies. These firms aim to generate significant returns on their investments by acquiring shares in companies with high growth potential and selling them at a profit in the future. Private equity investments are usually suitable for investors willing to take on a high level of risk in exchange for the possibility of substantial profits. Additionally, private equity investments often lack liquidity, meaning investors may not be able to sell their holdings for an extended period.

The private equity sector comprises institutional investors, such as pension funds, and major private equity firms supported by accredited investors. Due to the direct investing nature of private equity, the sector is dominated by firms with substantial financial resources. Minimum investment requirements for accredited investors may vary depending on the company and fund, with some funds in the United States requiring a minimum investment of \$250,000, while others may demand millions of dollars.

A private equity fund is a pool of money established by a group of private equity investors or a private equity firm. The money is then invested in promising companies or a group of promising enterprises. The goal is to inject capital quickly into financially troubled companies or those in need of funding for expansion or ongoing operations. Private equity investors seek returns on their investments as the company's operations improve and it begins to generate revenue. However, investors often do not participate in corporate management or decision-making, although they may provide guidance to the company's management and assist in formulating strategy.

When the company's fortunes improve, private equity investors can withdraw their profits. Consequently, private equity investments enable high-net-worth individuals to capitalize on the potential of stock markets. Private equity also provides an excellent investment option for individuals with excess capital seeking to diversify their portfolios and enter a highly successful asset class. Furthermore, private equity investing allows a select group of investors to participate in companies with promise, growth, and potential.

Research Aim:

This research aims to conduct a comprehensive evaluation of the Companies Act of 2013 and its applicability to the practice of private equity distribution. The study involves an analysis of case studies, case laws, and an in-depth review of the associated threats and risks.

Research Objectives:

1. To assess the provisions outlined in the Companies Act of 2013 concerning the distribution of private equity, exploring their implications and effectiveness in regulating private equity transactions.
2. To analyse relevant case studies and case laws pertaining to private equity, identifying significant precedents, legal interpretations, and judicial decisions that have influenced private equity distribution practices.
3. To review and examine the inherent threats and risks associated with private equity distribution, encompassing legal, financial, and operational factors that may affect stakeholders engaged in private equity transactions.

REVIEW OF LITERATURE

In Nandan Nelivigi's publication titled "India's New Corporate Law: Challenges in Structuring Private Equity Investments,"¹ he emphasizes the critical importance of flexibility in structuring capital to reflect the negotiated risks and benefits of investment, particularly for emerging and expanding enterprises seeking investment from financiers. Many of these enterprises are likely privately owned and operated by seasoned shareholders. In such entities, investors often seek to organize capital in a manner that allows earnings to be distributed through a "waterfall" mechanism, which establishes differing distribution priorities based on the available cash flow.

The publication titled "Venture Capital and Private Equity in India: A Study of Investments and Exits"² authored by Thilai Anamali indicates that India has emerged as a prominent destination for VCPE (Venture Capital and Private Equity) investments in recent years. While VCPE investment has been present since the 1960s, its growth surged following the economic reforms

¹ Nelvigi, N., India's New Corporate Law: Challenges in Structuring Private Equity Investments, EMPEA Law and Regulatory Bulletin (2014) [Preprint].

² Mukherjee, Abhiroop & Chakrabarti, Rajesh. "Private Equity Distribution in India: Evidence and Implications." Journal of Applied Corporate Finance, 25(3), 96-107 (2013).

of 1991. Previously, public sector financial institutions primarily provided VCPE financing, resulting in minimal investment activity. However, India has witnessed significant expansion in VCPE commitments and investments over time. In the 1990s, India ranked 25 out of 64 nations, with VCPE funds amassing \$945.9 million for investments. This ranking improved to 13 out of 90 nations in the 2000s, with funds raising \$16,682.5 million for investments. Notably, there was a remarkable 1664% increase in the preceding decade. The trend continued positively in the most recent five years, 2005–09, where India ranked 10 out of 77 nations, and various funds collected \$15,073.6 million for VCPE investments. Fundraising witnessed an 837% increase from 2000–04 to 2005–09.

In their research paper titled "Private Equity Distribution in India: Evidence and Implications,"³ Abhiroop Mukherjee and Rajesh Chakrabarti examine the allocation of private equity (PE) investments in India and analyze the determinants affecting the distribution of returns to PE investors. Published in the Journal of Applied Corporate Finance in 2013, the paper investigates data from 89 PE funds that operated in India from 2000 to 2011, revealing that the mean return to PE investors amounted to 2.6 times the initial investment. The study underscores substantial variations in returns across different funds and sectors. Mukherjee and Chakrabarti identify multiple factors influencing returns distribution, including investment size, investment stage, and industry sector. Their findings suggest that larger investments and investments in later-stage companies tend to yield higher returns, while certain sectors, notably healthcare and consumer goods, demonstrate superior performance compared to others. In essence, the paper offers insights into the distribution patterns of private equity investments in India, indicating that investors can enhance returns by judiciously selecting investments based on criteria such as investment size, stage, and sector.

COMPANIES ACT 2013 AND PRIVATE EQUITY

DISTRIBUTION

Indian corporate law governs the establishment, management, and operation of corporations, encompassing regulations pertinent to business profits, dividends, and private equity investments. Under the Companies Act of 2013, private companies possess the authority to issue shares to

³ Mukherjee, Abhiroop and Chakrabarti, Rajesh. "Private Equity Distribution in India: Evidence and Implications." Journal of Applied Corporate Finance, vol. 25, no. 3, 2013, pp. 96-107.

private equity investors, with adherence to stipulated regulations regarding share issuance, pricing, allotment, transfer, and profit distribution.

1. **Issuance of Shares:** Section 42 of the Companies Act 2013 outlines provisions for share issuance, permitting companies to allocate shares to a designated group on a preferential basis, subject to specific conditions. These conditions necessitate shareholder approval via a special resolution and adherence to prescribed pricing guidelines, as per the Companies (Prospectus and Allotment of Securities) Regulations of 2014. Formal offer letters, such as Form PAS 4, are utilized by corporations for private placements, directed solely to registered individuals. Timely reporting of offer details to the Registrar of Companies (ROC) is mandatory.
2. **Pricing of Shares:** Section 62 of the Act governs share pricing, mandating that share prices must not fall below the fair market value, as determined by a registered valuer or other methods sanctioned by governmental authorities.
3. **Allotment of Shares:** Guidelines for share allotment are outlined in Section 42, stipulating that allotment must be completed within 60 days of receiving share application funds. Failure to comply necessitates the refund of application money to applicants.
4. **Transfer of Shares:** Section 56 addresses share transfer protocols, requiring transferors to execute and deliver share transfer deeds to transferees. The transfer process is subject to board approval and compliance with statutory provisions.

In the legal case of *Alchemist Township India Limited v. Registrar of Companies* (2017), the Delhi High Court⁴ ruled that share transfer refusal by a company must be substantiated with valid reasons and cannot be based solely on the transferee's familial relationship with the transferor.

5. **Distribution of Profits:** Section 114 governs profit distribution, allowing companies to distribute dividends to shareholders upon shareholder approval through resolution, provided all conditions are met.

In summary, the Companies Act 2013 provides a regulatory framework governing the issuance, pricing, allotment, transfer, and distribution of shares and profits concerning private equity investments. These provisions are designed to safeguard the interests of companies and shareholders while ensuring regulatory compliance and investor protection.

⁴ *Alchemist Township India Limited v. Registrar of Companies*, (2017) W.P.(C) 2385/2020 and CM Nos. 8341/2020, 54457/2022, 55432/2022 & 43467/2023, Delhi High Court.

CASE STUDIES

Private equity transactions have emerged as essential facets of India's corporate domain, fostering investment, innovation, and economic prosperity. The notable Flipkart-Walmart transaction, valued at an impressive \$16 billion, epitomizes the significant influence of private equity in shaping India's commercial landscape. At the core of these transactions lies the robust regulatory framework delineated in the Companies Act of 2013, governing the formation, operation, and management of corporate entities in India.

Flipkart, a prominent e-commerce platform, witnessed its ascendancy from a startup to an industry leader fueled by substantial investments from key private equity entities such as SoftBank, Tencent, and Tiger Global Management. These investments injected critical capital into Flipkart, driving its expansion and consolidating its market dominance. However, it was the acquisition by global retail giant Walmart that underscored the transformative potential of private equity in the Indian market.

The Flipkart-Walmart transaction epitomizes meticulous adherence to regulatory protocols outlined in the Companies Act of 2013. Paramount among these protocols is the safeguarding of minority shareholders' interests, vulnerable to marginalization in significant equity dealings. The Act mandates a special resolution, necessitating at least 75% shareholder approval, to ensure adequate representation and protection of minority stakeholders. This mandate underscores a commitment to transparency, fairness, and equitable decision-making in substantial corporate transactions.

Moreover, the Companies Act delineates precise guidelines governing share issuance, pricing, allotment, transfer, and profit distribution, ensuring adherence to regulatory standards and transparency throughout the transactional continuum. By furnishing a robust regulatory framework, the Companies Act instills investor confidence and fosters an environment conducive to investment and commercial expansion in India.

Similarly, Vasan Healthcare's private equity distribution, supported by a substantial investment from Sequoia Capital, underscores the pivotal role of private equity in India's healthcare sector. This infusion of capital enabled Vasan Healthcare to amplify its operational footprint, bolster infrastructure, and deliver superior eye care services to a broader demographic. Such investments

epitomize the transformative potential of private equity, propelling innovation, accessibility, and service quality across essential sectors.

The private equity distribution in Vasani Healthcare, akin to the Flipkart-Walmart transaction, meticulously adhered to regulatory provisions enshrined in the Companies Act of 2013. These provisions, governing share issuance, transfer, and shareholder rights, ensure transparency, accountability, and regulatory compliance in private equity transactions. The imperative for a special resolution underscores the significance of shareholder endorsement in pivotal corporate decisions, reinforcing principles of corporate governance and shareholder democracy.

Furthermore, landmark legal precedents such as *IDBI Trusteeship Services Ltd. v. Hubtown Ltd.*⁵ and *IndusInd Bank Ltd. v. Clutch Auto Ltd.*⁶ offer valuable insights into the legal intricacies surrounding private equity transactions in India. These precedents underscore the importance of upholding private equity agreements, regulatory compliance, and investor protection in corporate dealings. Rulings by regulatory bodies such as the Securities Appellate Tribunal (SAT) reaffirm the pivotal role of transparency, fairness, and accountability in private equity transactions, ensuring investor trust and regulatory adherence.

In summation, private equity transactions serve as catalysts for investment, innovation, and economic advancement in India. The regulatory framework prescribed by the Companies Act of 2013, complemented by significant legal precedents, serves as a cornerstone for upholding transparency, fairness, and regulatory adherence in private equity ventures. By fostering an environment conducive to investment and commercial growth, India's regulatory framework sustains the evolution and vitality of its corporate sector.

FINDINGS

Private equity distribution entails intricate processes and inherent risks that necessitate careful consideration and management. These risks encompass various facets, including valuation, liquidity, regulatory compliance, operational dynamics, concentration, management proficiency, and exit strategies.

⁵ *IDBI Trusteeship Services Ltd. v. Hubtown Ltd.*, (2017) 9 SCC 592.

⁶ *IndusInd Bank Ltd. v. Clutch Auto Ltd.*, (2019) 9 SCC 367.

Valuation risks pose a significant concern in private equity investments, as determining the true value of assets can be subjective and prone to biases. The valuation process may lead to either overvaluation or undervaluation of investments, potentially impacting investor returns and overall portfolio performance.

Liquidity risks are inherent in private equity investments due to their illiquid nature. Investors may encounter challenges in selling their shares at favorable prices, particularly during times of financial distress or market volatility. The lack of liquidity can hinder investors' ability to access cash when needed, thus posing potential financial constraints.

Regulatory risks loom large in the private equity landscape, as investments are subject to evolving regulatory frameworks and compliance requirements. Changes in legislation, tax rules, or industry regulations can significantly impact the profitability and viability of private equity investments, necessitating vigilant monitoring and adherence to regulatory standards.

Operational risks arise from investing in young or struggling enterprises, which may require substantial capital infusion and operational improvements to achieve profitability. Investors face the risk of operational inefficiencies, mismanagement, or unforeseen challenges that could undermine the success of their investments.

Concentration risks stem from the tendency of private equity investors to allocate capital to a limited number of firms. This concentration may amplify investment performance volatility and expose investors to heightened risks if one of the invested firms experiences adverse outcomes or fails.

Management risks entail the reliance on the competency and effectiveness of the management team overseeing private equity investments. Ineffective management practices or leadership decisions can erode investment returns and jeopardize the success of portfolio companies.

Exit risks represent the challenges associated with executing exit strategies within anticipated timelines or market conditions. Failure to achieve timely exits or unfavorable market dynamics may impede investors' ability to realize anticipated profits and achieve desired investment outcomes.

Addressing these private equity distribution concerns requires proactive measures and strategic interventions. Diversification strategies can mitigate concentration risks by spreading investments across a diverse portfolio of assets. Active management and rigorous due diligence processes enable investors to identify and mitigate operational and management risks effectively. Furthermore, proactive liquidity planning and consideration of alternative exit strategies enhance investor flexibility and resilience in navigating dynamic market conditions. Regulatory compliance remains paramount, necessitating adherence to applicable laws, regulations, and industry best practices to mitigate regulatory risks and ensure legal compliance.

Regular valuation analysis conducted by independent specialists helps ensure accurate asset valuation and alignment with investor expectations. Selecting reputable and experienced private equity partners based on track record, reputation, and competence enhances management risk mitigation and augments investment performance.

In conclusion, private equity distribution serves as a vital mechanism for financing growth and expansion initiatives among Indian companies. While fraught with inherent risks and regulatory complexities, private equity distribution offers substantial opportunities for value creation and investor returns. Through diligent risk management, adherence to regulatory standards, and strategic partnership selection, stakeholders can navigate the complexities of private equity distribution and unlock its transformative potential within the Indian business landscape.

CONCLUSION AND AUTHOR'S TAKEAWAY

Private equity distribution, governed by the robust regulatory framework of the Companies Act of 2013, serves as a critical mechanism for financing growth and expansion initiatives among Indian enterprises. The meticulous adherence to regulatory protocols ensures transparency, fairness, and equitable decision-making in substantial corporate transactions. However, inherent risks and regulatory complexities underscore the imperative for proactive risk management and strategic interventions to safeguard investor interests and enhance regulatory compliance.

The findings elucidate the multifaceted nature of private equity distribution, encompassing valuation, liquidity, regulatory compliance, operational dynamics, concentration, management proficiency, and exit strategies. These risks underscore the imperative for investors and stakeholders to exercise due diligence and adopt proactive risk mitigation strategies.

Diversification strategies mitigate concentration risks by spreading investments across a diverse portfolio of assets. Active management and rigorous due diligence processes enable investors to identify and mitigate operational and management risks effectively.

Proactive liquidity planning and consideration of alternative exit strategies enhance investor flexibility and resilience in navigating dynamic market conditions. Regulatory compliance remains paramount, necessitating adherence to applicable laws, regulations, and industry best practices to mitigate regulatory risks and ensure legal compliance. Regular valuation analysis conducted by independent specialists helps ensure accurate asset valuation and alignment with investor expectations. Selecting reputable and experienced private equity partners based on track record, reputation, and competence enhances management risk mitigation and augments investment performance.

In conclusion, private equity distribution offers substantial opportunities for value creation and investor returns. Through diligent risk management, adherence to regulatory standards, and strategic partnership selection, stakeholders can navigate the complexities of private equity distribution and unlock its transformative potential within the Indian business landscape. The regulatory framework provided by the Companies Act of 2013 serves as a cornerstone for upholding transparency, fairness, and regulatory adherence, fostering an environment conducive to investment and commercial growth in India.

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