Corporate Governance: Shareholders' Agreement

From a corporate governance point of view, contractual protection and operational framework for shareholders are typically covered under the provisions of a shareholders' agreement ("**SHA**"). The lifecycle of an investment transaction typically begins at the execution of a soft commitment from investors (term sheet / letter of intent), followed by a comprehensive check of the company's health and viability by the investor (due diligence), followed by the relationship terms being recorded under an SHA and subscription / purchase agreements.

As explained below, shareholders can avail protective rights under law as well as under contract, under the terms of an SHA. Where a company has / may have subsidiaries, shareholders may also seek comparable rights in those subsidiaries.

1. *Inspection rights*: Shareholders have a legal right to inspect certain records of the company, and investors often negotiate additional rights in relation to visiting premises, consulting officers or conducting audits, often at the company's expense. These rights help monitor investments, collaborate with other stakeholders and address misconduct making these rights crucial, especially for minority shareholders who lack board access. Unlike some jurisdictions, notably, Indian law does not require shareholders to provide reasons for exercising their inspection rights.

2. *Information rights*: To ensure transparency, investors negotiate to obtain periodic information regarding the functioning of a company, which goes well beyond the information available to shareholders under company law. Investors avail information typically through a management information system (MIS) providing periodic financial and operational reports. This may include the company's annual budget and business plan. Where investors hold significant stakes, they may also gain approval rights over such plans, usually listed as affirmative vote rights / reserved matters (see below).

3. *Directorship*: Investors with significant stake often secure a right to appoint nominees on the board of directors of a company. In companies with many investors and fragmented shareholding patterns, this right is typically granted to institutional investors holding a minimum shareholding in the company (usually 5-15% of the share capital). These directors typically do not initiate proposals but otherwise have the right to approve / reject board actions, helping investors implement sound governance principles over the management and affairs of the company.

4. *Board observers*: Board observers are a creation of the industry (and not of statute) and refer to individuals appointed to attend and observe board meetings of a company, with no power to vote. Controlling shareholders can exert influence beyond their ownership, aligning management with their interests (*M/s Subhkam Ventures (I) Private Limited v SEBI, 2010 SCC Online SAT 35*). While the option of appointing 1 (one) director for minority shareholders, i.e., small shareholder director, exists in law, it is only optional [S. 265, CA 2013]. Hence, a board observer seat is crucial for minority shareholders to access real time information, and in hostile situations, seek timely remedy against oppression and mismanagement [S. 241, CA 2013].

5. *Shareholders' meetings*: Lead investors often require that shareholders' meetings be held with their representative being present. The company concerns are usually two-fold (a) deadlock due to

differing opinions, (b) non-attendance for mandatory quorum. While the typical solution is to adjourn and reconvene as per law, such adjournments should not continue ad infinitum. In such cases, parties to the SHA often agree to a fixed number of adjournments (typically 1 or 2) post which shareholders' meetings may be conducted in the absence of the representative. That said, affirmative voting rights / reserved matters are an exception to this rule and customarily, no reserved matter tabled for discussions can be determined without the presence of the representative.

6. *Affirmative vote rights / reserved matters*: Financial investors typically do not engage in overseeing the day-to-day functioning of a company and instead exercise discretion over key decisions termed as 'reserved matters' or 'affirmative voting matters'. Such matters can be approved only if the affirmative consent of the investor has been obtained. The list of affirmative vote rights typically ranges across matters such as fresh issue of capital, amendment to charter documents, or operational matters such as substantial deviation in the company's business, revisiting limits on expenditure, etc. In companies with multiple investors, it is typical for affirmative vote rights to be linked to a minimum shareholding threshold as well as be determined by collective wisdom of the majority. This ensures that while adequate checks and balances are instituted, neither small shareholders nor a single investor / minority of investors can block operations. Investors also insist that their affirmative vote rights are entrenched in the company's articles, making them practically incontestable. While attempts (including by SEBI trying to lay down a bright-line test) have been made under law to define the construct of reserved matters that may amount to the holders of such rights having 'control' over a company, this conundrum continues to challenge legal minds and is more often than not determined on a case to case basis.

7. *Covenants*: As the name suggests, covenants are simply undertakings or forward-looking actions that obligate a company to do / not to do certain acts that relate to the affairs of the conduct business. The intent here is for investors to create perimeters within which the affairs should be run, ensuring a framework of good governance and limiting the scope of mismanagement. These covenants cover a variety of matters including business plans and budgets, audit requirements, strong anti-bribery and anti-corruption frameworks, rules for dealing with sanctioned territories nations and other industry specific ESG matters.

8. *Non-compete and non-solicitation provisions*: To protect a company's business and its stakeholders interests, investors often impose non-compete provisions on promoters / founders, restricting them from undertaking the same / similar business activities not only during their involvement with the company but also once their engagement seizes, for a reasonable time and defined geographical territory. While common in private equity and venture capital transactions, such provisions have to be carefully crafted in India to ensure they are not considered being unreasonably restrictive of constitutional trade freedoms and Section 27 of the Indian Contract Act, 1872. While most common law jurisdictions attempt to balance company interests with promoter rights, Indian courts have largely prioritized the promoters' right to trade.

   In addition to non-compete provisions non-solicitation clauses prevent promoters / founders from self-dealing by having embargos on poaching key employees, clients and vendors from the company. They too apply for a limited period after cessation of the relationship with the company.

The SHA has evolved as a critical instrument in corporate governance, particularly within private companies where shareholder dynamics are closely held and keenly negotiated. While public markets rely on strict regulatory oversight and disclosure norms, SHAs play a key role in defining rights,

responsibilities and contractual remedies among shareholders. Such rights are folded into the articles of association of a company to ensure these are binding on such company and their enforcement is watertight. As governance norms become more defined in private companies, SHAs will continue to play a pivotal role in balancing the interests of minority and controlling shareholders, as well as reinforcing obligations and value protection in companies.

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