Corporate Governance: Contractual Remedies for Breaches and Mismanagement

Shareholders agreements (**SHA**) are no exception to '*ubi jus ibi remedium*'. In our previous article, we described how the management of a company often owes allegiance to controlling shareholders, while other shareholders retain a right against abuse of such power. Much like 'rights', which are made available either statutorily in the Companies Act, 2013 (**Act**) and/or contractually, to shareholders, the 'remedies' (a) against abuse of power by management/controlling shareholders, and (b) for protection of shareholder rights, are made available under statute or by contract. In this article, we highlight the contractual remedies that are typically available to shareholders of a company.

Rights to protect shareholding against dilution

Investors typically have certain contractual rights that protect against dilution in case of any new funding round taking place in the company:

1. Pre-emptive rights

Pre-emptive rights are meant to be the first line of defence against dilution. Pre-emptive rights / pay to play rights give a shareholder the ability to not be diluted if it is willing to participate in an upcoming funding round to maintain its shareholding as it stood immediately prior to such funding taking place. This right is typically provided to all investors who hold a certain minimum shareholding threshold typically arrived at keeping in mind the balance between access to capital, administrative convenience and having a well-diversified shareholder base.

2. Right of first offer (ROFO)/ Right of first refusal (ROFR) / Tag along rights

ROFR and ROFO are key contractual protections in shareholder agreements that help maintain a shareholder's ownership structure. ROFR gives an existing shareholder the right to match any third-party offer made to a selling shareholder before shares are sold externally, whereas ROFO requires the selling shareholder to first offer their shares to existing shareholders before seeking third party buyers. When a shareholder is selling its shares, ROFR / ROFO give the existing shareholders the first rights to buy shares before an outsider can thus, allowing for existing shareholders to increase their shareholding in the company, preventing dilution from new entrants. These are powerful safeguards against secondary dilution through external share transfers.

Tag along rights allow investors / shareholders to sell their shares on the same terms as the founders that sell their stake to a third party. This ensures fair exit opportunities and prevents a situation where control shifts without giving investors a chance to monetize their investment. This prevents value erosion and preserves balance and transparency in ownership transitions.

3. Anti-dilution rights / Rachet protection

Anti-dilution rights or rachet protection help investors preserve the economic value of their investment in the company in case future fund raises take place at a valuation that is lower than the valuation at

which such investors had invested in the company (commonly known as a 'down-round'). In such cases, to protect against value-dilution, the number of shares that investors should hold are increased by adjusting the conversion ratio in case of convertible securities or by issuing fresh shares at a lower valuation. Such anti-dilution is typically achieved either through a full ratchet anti-dilution mechanism or through a broad based weighted average method (both being different in terms of the extent of additional shares being issued, with the former being favourable to an investor). The additional shares are issued such that the economic interest of the investor is retained as far as reasonably possible. Broad based weighted average anti-dilution is the more accepted mechanism these days to achieve any anti-dilution protection to an investor, as this is calculated on a weighted average formula basis and does not adversely impact the founders solely.

Breach or bad acts by founders

1. Vesting and Reverse Vesting

In order to have founders retain skin in the game, investors typically negotiate for a vesting schedule to be incorporated in the SHA. The vesting schedule typically spans across 3 to 5 years for a slow release of the shares held by the founders. Investors require founders to continue to be employed in the company until the investors exit completely (or at the minimum 4-5 years from the date of their investment), following which founders would have been vested with all their shares and effectively "earned back" their shares.

Investors further structure protections in the SHA for bad acts or worst case scenarios such as occurrence of 'cause' events or situations where a founder resigns from the company without consent of the investors or eventualities like death or permanent disability of a founder wherein the released shares / vested shares are clawed back by the company (either via buy-back or transfer to an employee welfare trust or a preferred individual etc. as decided by the board). This is to ensure business continuity and availability of shareholding to be reallocated to management who are likely to take on the responsibilities of the exiting founder. For obvious reasons, this is often the most negotiated provisions in an SHA.

2. Cause events

Most Indian companies tend to be founder led, with founders occupying key positions in the executive management or C-suite. While the terms of employment of the individual founder(s) and other key individuals are set out in employment agreements, it is not uncommon to see 'cause' events and other analogous terms in shareholder agreements, outlining actions or occurrences which would give rise to a cause for penalising the concerned founder.

What constitutes 'cause' is heavily negotiated and it typically includes events such as charges for criminal offences, fraud, embezzlement, wilful misconduct, charges of sexual harassment at the workplace, abandonment / resignation without investor approval, material breaches of the SHA and employment terms. Occurrence of a cause event by a founder in a company is of major concern to investors on account of being operationally challenging (as founders are the face of a company) and could damage the reputation and prospects of a company. Investors contractually build remedial protections for these scenarios ranging from termination of the founder's employment and clawback of shares held by the founders.

The extent of shares to be clawed back is also a debatable topic during deal making, considering founders have earned those shares with their time and effort and want to maximise on what they can retain; and investors having to manage a new executive being appointed in place of the defaulting founder to salvage the operations of the company in the best manner possible.

In cases of a 'cause' event occurring, given the grave nature of the occurrence, the ask is often that 100% of the vested and unvested shares are taken away from the defaulting founder and repurposed in the best manner the board determines. Founders are also provided with an opportunity to be heard in such situations and any discussions would follow the principals of natural justice to ensure it is fair trial before an event of cause is concluded. Clawback of founder shares however is still one of the strongest deterrents in an SHA, ensuring that equity is earned, not entitled and misconduct has real, enforceable consequences.

Breach by the company

So far, we have looked at the rights available to investors against the company, other shareholders and founders. Below are the contractual protections for investors in case the company, other shareholders or founders breach any of their contractual obligations.

Events of default

A breach of affirmative vote matters and covenants / representations and warranties (as discussed in our previous article) or occurrence of a share transfer in violation of the provisions of the SHA, or in some situations the occurrence of a 'cause' event (as discussed above) *inter alia*, fall under the umbrella of an 'event of default'. An 'event of default' may also include insolvency proceedings against the Company or fraud, wilful misconduct etc. by a Company (as typically determined by an acceptable third-party).

Upon the occurrence of an 'event of default', share transfer restrictions applicable to investors fall away (including restriction on transferring shares to a competitor of the company) and investors are entitled to (a) accelerated exit rights and step-in rights to take over operational control of the company (by appointment or dismissal of directors), retain the right to transfer their shares to defined competitors of the company, and / or (b) indemnity, should investors suffer losses.

From a governance standpoint, EOD provisions are crucial as it protects the interests of minority shareholders, acts as a deterrent to encourage compliance and prevents abuse of power in founder-led companies where checks and balances can be maintained to avoid governance failures.

In essence, while SHAs safeguard against unforeseen circumstances, these are not triggered as frequently as, investors also understand that building a company ground up is a herculean task and do not trigger 'cause' events unless it is grave or irreparably damaging to the company. Triggering a 'cause' event by an investor often marks the end of the road for the company's leadership, signalling a breakdown in trust and governance. Yet, such clauses set a high bar for integrity serving as a powerful reminder that accountability is non-negotiable in serious, investor-backed enterprises.

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