PRE-EMPTIVE RIGHTS AND THEIR IMPACT ON FUNDRAISING IN PE DEALS

ABSTRACT

Pre-emptive rights are the ultimate shield for shareholders, ensuring their ownership remains intact amidst future fundraising. These rights, whether statutory, contractual, or negotiated, are pivotal in private equity (PE) transactions but can complicate fundraising dynamics. This article examines the types of Pre-emptive rights, how they are structured and their impact on fundraising in key transactional documents. It discusses how these rights are structured in transaction documents to balance shareholder protection with the need of the Company for funding.

This article aims to delves into the impact of pre-emptive rights on fundraising, highlighting the challenges they pose, such as potential delays or complications with new investors. The real-world case studies viz. *Shanti Prasad Jain v. Kalinga Tubes Ltd., AIR 1965 SC 1535* and *Western Maharashtra Development Corporation v. Bajaj Auto Ltd., Appeal No. 153 of 2010 in Arbitration Petition No. 174 of 2006, decided on May 8, 2015*, are analysed to demonstrate the differing enforceability of these rights in private and public companies. Additionally, the article offers insights into structuring these rights and share transfer restrictions, such as lock-in periods and Right of First Refusal (ROFR)/ Right of First Offer (ROFO) clauses, to ensure flexibility and prevent hindrances to capital infusion. It emphasizes how well-structured pre-emptive rights can foster shareholder stability, support effective fundraising, and encourage long-term investor commitment in private equity markets.

TYPES OF PRE-EMPTIVE RIGHTS

Pre-emptive rights take various forms, each tailored to address specific shareholder concerns and scenarios in private equity transactions. These rights ensure that existing shareholders can protect their interests during share issuance or sales, maintaining their proportional ownership and influence within the Company. The key types of pre-emptive rights include:

1. **Right of First Refusal (ROFR)**: Under ROFR, existing shareholders have the right to match any offer made by a third party to purchase shares. This provides them with the ability to prevent the entry of external investors who may not align with the vision of the Company.

2. **Right of First Offer (ROFO)**: When a shareholder decides to sell their shares, a ROFO clause requires them to offer the shares first to existing shareholders at a predetermined price and only if the shareholders declines, can the seller approach the external buyers.

3. **Rights of Co-Sale**: This right allows shareholders to sell their shares in conjunction with another shareholder who intends to sell their stake. It ensures all shareholders have the opportunity to participate in significant liquidity events.
4. **Pro-Rata Pre-emptive Right**: This right allows existing shareholders to purchase newly offered shares on a pro-rata basis before they are made available to external buyers. It ensures shareholders have the first opportunity to maintain their ownership percentage during capital raises.
5. **Full Pre-emptive Rights**: Existing shareholders can purchase additional shares in any subsequent offering, thereby maintaining their ownership percentage. This right offers stronger protection for existing shareholders.
6. **Partial Pre-emptive Rights**: This limits the extent to which a shareholders can participate in an additional offering, allowing them to only purchase a portion of the new shares, potentially leading to more significant dilution of ownership.

STRUCTURE AND IMPACT OF PRE-EMPTIVE RIGHTS IN TRANSACTION DOCUMENTS

Pre-emptive rights, commonly included in transaction documents, are structured as contractual provisions granting existing shareholders the first opportunity to purchase new shares issued by the Company before they are offered to others. These rights are designed to protect shareholders from dilution by enabling them to maintain their proportional ownership within the Company. The provisions typically specify detailed conditions and procedures, including the number of shares each shareholder is entitled to purchase based on their current ownership percentage, the price of the new shares, and the timeframe for exercising the rights.

While these rights bolster investor confidence and promote long-term commitment, their impact on transaction documents extends beyond mere shareholder protection. On the positive side, Pre-emptive rights encourage reinvestment during subsequent funding rounds and streamline the fundraising process by allowing existing shareholders to inject additional funds, thereby reducing reliance on external investors. However, these rights can also pose challenges, such as delaying the fundraising process due to the need to notify shareholders and provide them with a window to exercise their rights. This delay can hinder deal closures and discourage new investors who might view the allocation process as rigid or overly controlled by existing shareholders. Moreover, conflicts may arise when Pre-emptive rights are exercised at valuations lower than expected by new investors, potentially leading to renegotiations or disputes.

To mitigate these challenges, transaction documents often include customized provisions to balance the rights of existing shareholders with the need for new capital. These may include waivers or modifications of Pre-emptive rights for specific rounds, particularly when strategic investors are involved or when substantial capital infusions are required. Time-bound clauses ensure that Pre-emptive rights are exercised within a defined period, preventing unnecessary delays. The Company may set up certain thresholds may be set, limiting the application of Pre-emptive rights to smaller funding rounds, while strategic investors may be excluded from triggering these rights to enable flexibility in securing partnerships that bring value beyond capital. By carefully structuring and negotiating these provisions, Pre-emptive rights can be effectively incorporated into transaction documents, ensuring that shareholder protection does not impede the Company's growth or its ability to attract new investments.

In addition to Pre-emptive rights, private companies often impose share transfer restrictions to maintain stability in shareholding and protect long-term interests. A common restriction is the lock-in period, which prevents shareholders, particularly promoters or investors, from transferring their shares for a specified duration, typically two to three years. For instance, in private equity deals, promoters may be locked in to ensure their continued commitment to the business, while investors may agree to a similar restriction to stabilize the Company's ownership structure. Once the lock-in period ends, share transfers are often subject to partial restrictions such as Right of First Offer (ROFO) and Right of First Refusal (ROFR).

Under ROFO, an investor who wishes to sell their shares must first offer them to the existing shareholders, typically the promoters, before approaching third-party buyers. If the promoters decline the offer, the investor may sell to an external buyer, but this process may place the promoters at a disadvantage if the external buyer agrees to a higher price. In contrast, ROFR gives existing shareholders the right to match the terms of a sale negotiated by the investor with a third-party buyer. This mechanism provides promoters with greater control, as they are informed of the buyer's identity and the proposed sale terms. ROFR is particularly beneficial for promoters in preventing competitors from acquiring shares, as it incentivizes them to match the external offer when necessary.

Both ROFO and ROFR create partial restrictions on share transfers, ensuring that investors cannot sell their shares entirely without the involvement of existing shareholders. This is critical for maintaining the integrity of ownership and protecting the Company's long-term vision. The enforceability of such restrictions has been upheld by courts, as seen in *Messer Holdings Limited vs. Shyam Madanmohan Ruia and Ors.*, where the Bombay High Court ruled that share transfer restrictions are enforceable when included in the Company's Articles of Association.

REAL-WORLD SCENARIOS: PRE-EMPTIVE RIGHTS IN PRIVATE AND PUBLIC COMPANIES

Pre-emptive rights serve as a critical safeguard in corporate governance, protecting existing shareholders from the dilution of their ownership stakes and ensuring fairness in share allotments. These rights grant shareholders the opportunity to maintain their proportional ownership by giving them the first option to purchase newly issued shares before they are offered to external parties. However, the application and enforceability of pre-emptive rights can vary significantly depending on whether the Company in question is a private or a public Company, as seen in two contrasting cases, Shanti Prasad Jain v. Kalinga Tubes Ltd. and Western Maharashtra Development Corporation v. Bajaj Auto Ltd[1].

In the Shanti Prasad Jain v. Kalinga Tubes Ltd. case, the Supreme Court of India addressed a situation in a private Company where the majority shareholders had unfairly allotted 39,000 new shares without offering the existing minority shareholders the opportunity to subscribe.

[1] AIR 1965 SC 1535

This action diluted the minority's stake, giving the majority further control over the Company. The Court ruled that the allotment violated the fundamental principles of pre-emptive rights, which are designed to ensure proportional ownership among shareholders. The Court invalidated the allotment and directed that the shares be transferred to the petitioner, reinforcing the importance to respect the rights, prevent oppression and maintain fairness in share allotment practices of private companies. The case emphasizes the practical application of pre-emptive rights in private companies, where shareholder agreements often include provisions that protect against dilution by prioritizing existing shareholders for new shares.

On the other hand, Western Maharashtra Development Corporation v. Bajaj Auto Ltd.[2] presents a contrasting scenario in a public Company. Here, the Bombay High Court examined an agreement between Bajaj Auto ("BAL") and Western Maharashtra Development Corporation ("WMDC"), which granted a right of pre-emption if either party seeks to transfer its shareholding in Maharashtra Scooters Ltd. ("MSL"). The case arose when WMDC offered to sell its 27% shareholding to BAL, but BAL found the price unacceptable. WMDC challenged the arbitrator's decision on the grounds that the agreement violated Section 3A of the Companies Act, 1956, which mandates that there can be no restrictions on the transferability of shares in public companies. The Court upheld this argument, ruling that the pre-emption clause was invalid, as it placed restrictions on share transferability in a public Company, thus violating statutory provisions. This case underscores the legal limitation of enforcing pre-emptive rights in public companies, where the transfer of shares is required to be unrestricted to maintain liquidity and marketability. Under Section 58 of the Companies Act, 2013, the transfer of securities in a public Company is subject to restrictions only as per the Articles of Association, and any agreement that places restrictions on the free transferability of shares contravenes this provision.

Together, these cases highlight the differing treatment of pre-emptive rights in private and public companies. While pre-emptive rights are enforceable and critical in private companies to prevent dilution and protect minority shareholders, they face significant limitations in public companies, where restrictions on share transferability are prohibited by law. Both cases stress upon the importance of incorporating pre-emptive rights in transaction documents but also illustrate how the regulatory framework for public companies can conflict with such provisions, particularly when they restrict the free transfer of shares.

ANALYSIS

Pre-emptive rights are essential mechanisms that safeguard existing shareholders from dilution by offering them the first opportunity to purchase new shares before they are offered to external investors. They are particularly beneficial in private equity transactions, where they help maintain proportional ownership and provide stability within the shareholders base. However, as highlighted in both private and public Company cases like Shanti Prasad Jain v. Kalinga Tubes Ltd. and Western Maharashtra Development Corporation v. Bajaj Auto Ltd., the enforceability and impact of these rights differ significantly depending on the Company

[2] MANU/MH/0109/2010

structure. In private companies, pre-emptive rights are crucial for protecting minority shareholders, while in public companies, such rights are often limited by regulations requiring unrestricted transferability of shares.

From my perspective, pre-emptive rights should be incorporated in a manner that creates a win-win situation for both the Company and its shareholders. When structured properly, they not only encourage capital inflow but also ensure that existing investors can maintain a stable ownership percentage, particularly in funding rounds at higher valuations. This stability can help attract long-term investors who are confident in the future of the Company.

While Pre-emptive rights and share transfer restrictions offer significant benefits in protecting shareholder interests and ensuring stability, they must be carefully structured in transaction documents to avoid impeding the Company's fundraising potential. Lock-in periods and restrictions like ROFO and ROFR provide stability but may discourage new investors due to perceived rigidity. To strike a balance, transaction documents can incorporate flexibility, such as time-bound restrictions or carve-outs for strategic investors, ensuring that shareholding stability does not compromise the Company's ability to attract fresh capital or secure beneficial partnerships. By combining well-structured Pre-emptive rights with thoughtfully designed share transfer restrictions, companies can create a conducive environment for both shareholder protection and effective fundraising in private equity transactions.