Nishith Desai Associates
LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI SILICON VALLEY BANGALORE SINGAPORE MUMBAI BKC NEW DELHI MUNICH NEW YORK

Life Cycle of an India Focused Fund

Tackling Disputes

September 2016

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NDA's Private Equity Regulatory and Disputes Practice

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I. Our Approach

At Nishith Desai Associates, we are mindful that private equity investors face unique challenges during their investment cycle in India. Several judicial and regulatory hurdles have to be crossed while trying to achieve the best commercial return on the investment. Internationally private equity investors do not frequently get into disputes, but in India lately it has become common.

By combining experience in the fund formation and investment space with our expertise in handling high value complex commercial cross border disputes we provide our clients specialized advice beyond the fund formation and investment stage through the investment cycle, helping investors to cross the regulatory hurdles and achieve a commercially viable timely exit.

With our commercial intellect of the funds and private equity industry, understanding of cross-border tax issues and knowledge of international commercial arbitrations and international dispute resolution, we provide personalized solutions aimed at providing "interest based" options to the regulatory challenges and contractual disputes faced by private equities.

Our presence in Silicon Valley, Singapore and Munich and experience in representing clients before Singapore International Arbitration Centre, London Court of International Arbitration, International Commercial Court and International Centre for Dispute Resolution enables us to provide dispute resolution strategies across important jurisdictions in United States, Europe and South East Asia

While we are only authorized to practice Indian law, the Team comprises of professionals who are qualified in India, UK and the US and who have an understanding of cross-border dispute resolution as well as conflict of laws issues, a skill set we believe is essential for strategizing private equity disputes. This also helps us in seamlessly coordinating and strategizing with foreign legal experts, who are essential part of any cross-border project.

As a research based law firm, we also constantly update our capabilities through comparative research and analyses, which enable us to manage projects spanning multiple jurisdictions and which may require the reconciliation of a strategy with applicable Indian and non-Indian laws while keeping the commercial outcome in mind.

II. Commonly Seen Problems

i. Siphoning of Assets

ii. Corruption by Indian target

iii. Fraud and misrepresentations by business partners

iv. Breach of contractual covenants

v. Exercise of Exit options

vi. Directors Liability

vii. Communications and representations before regulators

viii. White collar crimes and criminal investigation

ix. Inter-fund disputes between LPs, GPs and managers

x. Litigation Funding

III. Representative Clients

Aberdeen,

Asia Pacific Capital,

Bessemer Venture Partners

Blackstone

Everstone

General Atlantic

Goldman Sachs

Global Investment House

Halcyon Finance & Capital Advisors Private Limited,

Morgan Stanley

Soros Fund Management,

India Venture Advisors

IV. Accolades

Our clients have recognized our expertise and thus:

i. Nishith Desai Associates has been declared as the Most Innovative Law Firm in Asia Pacific (2016) at the Innovative Lawyers Asia-Pacific Awards by the Financial Times - RSG Consulting

ii. Dispute Resolution Practice of Nishith Desai Associates has been recognized as "Highly Recommended" by Asia Law Profiles, 2016;

iii. Awarded by IDEX Legal Awards 2015 - Best Dispute Management Law firm of the year

iv. In 2014 IFLR1000 has ranked Nishith Desai Associates as Tier 1 law firm in India for advising Private Equity

v. Chambers and Partners for three years in a row (2011, 2012, 2013) ranked Nishith Desai Associates as No.1 law firm in India for advising Private Equity

vi. In 2011 Asian-Mena Counsel named Nishith Desai Associates In-House Community Firm of The Year in India for International Arbitration

NDA's International Litigation and Dispute Resolution Practice

Globalization and the growth of international commerce have created an unprecedented need to efficiently resolve cross-border disputes. With the evolution of effective and efficient arbitration systems, complex issues relating to enforcement of foreign arbitration awards and judgments are constantly being deliberated upon. For arbitration to gain prominence as the preferred mode of dispute resolution an in-depth analysis of the various legal issues arising therein is required. Mediation is also gaining popularity as a form of dispute resolution.

At Nishith Desai Associates (**"NDA"**), the International Litigation & Dispute Resolution Team has developed strong expertise and carved a niche in the area of inbound and outbound litigation, international arbitration and dispute resolution with a strong focus on complex cross border disputes and corporate frauds across industries. At NDA, we strive to provide clients with creative and pragmatic solutions and effective prelitigation strategies.

The team was credited when they were awarded Asian-Mena Counsel 'In-House Community Firm of the Year' in India International Arbitration (2011).

The Team has represented clients before international arbitration Centers such as the London Court of International Arbitration (LCIA), Singapore International Arbitration Centre (SIAC), International Chamber of Commerce (ICC), and International Centre for Dispute Resolution (ICDR - AAA) amongst others. The Team's understanding of modern cross border litigation issues comes from their experience before to various foreign courts such as courts of California, New York, Las Vegas, London, Singapore, Belgium, Bahrain to name a few.

The team has equally versatile experience before various Indian Courts and Tribunals such as High Courts of Bombay, Delhi, Chennai, Calcutta, Gujarat and Supreme Court of India.

Below are a few examples of some high stakes cross border disputes handled by the team in 2012-2013

i. Advising a telecom giant in a multi-billion dollar investment arbitration against Government of India.

ii. Representing India's largest post production house in a multi-million dollar dispute against a private equity investor before SIAC, Singapore.

iii. Representing an Indian cables manufacture in a multi-million Euro joint venture dispute against its Italian partner before the LCIA, UK.

iv. Representing minority shareholders of a pharmaceutical company against its American Joint Venture partner in a multi-million dollar arbitration before the SIAC, Singapore.

v. Representing one of the largest hydro project in India by way of public-private partnership which had multi -million dollar investment by six large private equity players in series of litigation and arbitration proceedings.

vi Advising an Indian apparel manufacturer against the State of California for alleged anti-trust violations under Californian Law before the State Court of County of LA.

vii. Independent Expert in a multi-million dollar family dispute between one of the largest real estate India family group

before the LCIA; in a multi-million dollar estate dispute before the Singapore High Court and in international tax dispute before the SIAC, Singapore involving issues relating to withholding taxes on payments of royalty made by an Indian resident to a Singapore resident

viii. Representing a large private equity and an American managed services provider in relation to a multimillion dollar FCCB default dispute before the High Court of Bombay and Supreme Court of India.

ix Advised several private equity funds and real estate funds providing effective exit strategies given the complex Indian regulatory environment.

Focus Areas

International Commercial Arbitration

Corporate, Securities & Regulatory Litigation

Private Equity Investment Disputes

Competition and Anti-trust litigation

Investment Treaty arbitrations

International Tax Litigation

HR Litigation

IP and Patent Litigation

White Collar and Economic Offences

Contents

1. Introduction

The life cycle of a typical investment fund ("**Funds**") consists of four stages. The first stage of a Fund's life cycle is to establish the investment vehicles that collect capital from investors or limited partners. At times such an investment vehicle may also be a joint venture between two or more Funds with one or more acting as the General Partner, and the remaining as Limited Partners. At the second stage, the capital thus raised is used to make debt or equity investments in high-potential companies following a clearly defined strategy.

Funds generally do not intend to maintain investments for an indefinite period of time. Instead, they seek to make the investment, implement value adding changes and then realize the resulting capital gain by disposing of their investment within a relatively short time frame which is generally 3-5 years. Hence, the third and penultimate stage of the Funds life cycle is to exit the investment. An important requirement is a timely and profitable exit not only to redeem capital and returns to their investors and themselves, but also to establish and maintain their reputation. Thisin turn, enables them to raise capital again for future funds from existing and new limited partners.

Finally, the capital recovered from the exit is redistributed to original investors on a pro-rata basis depending on the size of their initial investment. These reimbursements along with the capital gains, allow the institutional investors in the Fund to honor their insurance contracts, pensions and savings deposits, etc. This completes one business cycle or life cycle of a Fund.

During the first two stages of its life cycle Funds enter into several complex cross border commercial contracts to safe guard their rights and interests. These include agreements with managers and advisors during incorporation; with investors and joint venture partners at the time of fund raising, and with the target at the time of investment. It is thus important for every decision maker in a Fund to understand the legal nuances involved in interpreting and enforcing the contracts and the rights and remedies available for non-performance. This not only aids decision making, but enables the decision makers to assess legal feasibility of the objectives in mind thus eliminating the expectation mismatch between business and law.

In the first decade of the new millennium, many India focused Funds came into being and went through the first and second stage of their life cycles. At that time though their existed clearly defined strategies, being a fairly new industry, one could not predict the unique challenges and difficulties the Fund would face in India. With passing time certain common difficulties have come to the forefront. This paper aims to summarize the legal nuances under Indian law involved in interpreting and enforcing investment agreements and the rights and remedies available for non-performance with a focus on (i) contractual misrepresentations and fraud (ii) non-performance of material obligations (iii) failure to maintain transparent governance.

2. Contractual Misrepresentations and Fraud

For an agreement to be a valid contract under Indian Law, it is essential that it is made by the free consent of parties.[1] Consent is said to be free when it is not caused by inter alia misrepresentation and fraud.[2] Thus in cases of misrepresentation and fraud, the law recognizes the right of investors to cancel the investment agreement as these cases effect the consent of the investors to enter into the transaction in the first place.

I. Meaning

An action or omission is a "fraud" when a party to the contract, or any other person with his connivance, or his agent makes a false assertion, active concealment or promise to do something without the intention of performing it, with the intent to deceive the other party thereto or his agent, or to induce him to enter into the contract.[3] Thus, under Indian Law, unlike English Law, besides false assertions and active concealment, even making a promise (*a covenant*) without the intention of performing it amount to fraud.[4]

Misrepresentation on the other hand can be classified into three broad categories (i) a statement of fact, which if false, and the maker believes it to be true though it is not justified by the information he possesses; (ii) any breach of duty which gains an advantage to the person committing it by misleading another to his prejudice, even though there is no intention to deceive; and (iii) causing a party to an agreement to make a mistake as to the substance of the thing which is the subject of the agreement, even though done innocently.[5]

Thus, the principle difference between fraud and misrepresentation, under Indian Law is that in the first case the person making the suggestion does not believe it to be true and in the other he believes it to be true, though in both the cases, it is a misstatement of fact which misleads the other party entering into the contract.[6]

II. Effect & Remedies

When consent to an agreement is so caused by either fraud or misrepresentation, the agreement is a contract voidable at the option of the party whose consent was so caused.[7] Thus, a party who enters into an agreement based on certain misrepresentation or is defrauded into entering into an agreement has a right to rescind the agreement, and upon such rescission each party who has received any benefit under the impugned contract is required to restore such benefit to the person from whom it was received or make compensation for it to that extent or both.[8]

But not every misstatement or concealment of fact renders a contract liable to be avoided. Remedies available can only be exercised if the misrepresentation and/or fraud pertains to a material fact. A representation is material when a reasonable man would have been influenced by it in deciding whether or

1. Section 10 of the Indian Contract Act, 1872 (**"Contract Act"**)
2. Section 14 of the Contract Act.
3. Pollock & Mulla, Indian Contract and Specific Relief Act 388 (14th Edition, 2012)
4. *Laxmibai v. Keshav Annaj Pokharkar*, AIR 1916 Bom 239
5. Pollock & Mulla, Indian Contract and Specific Relief Act 402 (14th Edition, 2012)
6. *Niaz Ahmed Khan v. Parsottam* Chandra, 53 All 374; Rattan Lal Ahluwalia v. Jai Janinder Parshad, AIR 1976 P&H 200.
7. Section 19 of the Contract Act.
8. Section 64 r/w Section 65 of the Contract Act; Section 30 of the Contract Act.

not to enter into the contract.[9] Only a fact which materially influences the making of a contract or determining, whether to accept or not to accept a proposal is a material fact which if incorrectly stated may amount to misrepresentation or fraud.[10] It is thus important to cover all material representation in a transaction for an investment agreement. Also, recitals to an agreement which cover the background of the deal can be used to capture certain representations which cannot be expressly negotiated though essential in making the decision to invest as such recitals elicit the intentions of the parties while entering into the agreement.

A party to the contract, whose consent was caused by fraud or misrepresentation, may, if he thinks fit, in addition and/or in alternate to rescission, insist that the contract be performed, and that he shall be put in a position in which he would have been if the representations made had been true in the form of damages or restitution.[11] The measure of damage recoverable, in such a case, is essentially the same as is applicable to the tort of deceit[12], i.e. all the actual loss directly flowing from the transaction induced by the fraud, including the heads of consequential loss, and not merely the loss which was reasonably foreseeable.[13] Thus, in cases of misrepresentation and fraud, besides the rights available under an investment agreement, the law recognizes the rights to cancel the investment agreement and seek return of the principle investment along with reasonable interest.

III. Limitation

The law requires that when a party exercises his option to rescind the contract, he must be in a state to rescind; that is, he must be in such a situation to be able to put the parties into their original state before the contract,[14] implying that rescission is possible only when the parties can be restored to substantially the same position as they were before the contract was made,[15] and where restitution is not possible there cannot be rescission.

Thus in cases where a certain part of the investment is sold to the third party or where the investor derives other benefits besides the investment instrument, in such situation rescission may not be an available remedy. In such situations the appropriate remedy would be to seek damages and where plausible, specific performance of the representation. These are discussed in detail in the section below.

9. *Bhagwani Bai v. Life Insurance Corpn of India*, AIR 1984 MP 126 at 129.
10. *Geroge P Varghese v. G Daniel*, AIR 1988 Ker 120.
11. Section 19 of the Contract Act.
12. *Prithuram Kalita v. Mayaram Sarma*, AIR 1925 Cal 555
13. *Smith New Court Securities Ltd v. Scrimgeour Vickers*, (Asset Management) Ltd., [1996] 4 All ER 769.
14. *Clarke v. Dickson*, (1858) EB & E 148 per Crompton J at 154
15. *Solle v. Butcher*, 1950 1 KB 671

3. Non-Performance of Material Obligations

I. Repudiatory Breach

When a party fails to perform or refuses to perform or disables himself from performing any obligation under a contract, in each case in such a manner as to show an intention not to fulfill his part of the contract, and if the result is likely to deprive the innocent party of substantially the whole benefit of the contract such a breach or non-performance is regarded as material/ repudiatory breach of a contract.

II. Remedies

In such a situation the innocent party has a right to accept the repudiation, put the agreement to an end and bring an action to seek damages/ compensation for the losses suffered by him for the breach. Alternatively, the innocent party can seek specific performance of the contract and compel the breaching party to perform his part of the contract. Alternatively, the innocent party may only choose to sue for damages caused to it by the breach of contract and continue the remaining contract.

III. Specific Performance

Specific performance is an equitable relief granted by the courts when there has been a breach of contract. In such cases the court directs a defendant to perform his obligation under the investment agreements according to its terms and stipulations. In many cases, like in cases of breach of exit clause, a Fund is not interested in the compensation for breach of the investment agreement, rather the objective is to achieve a timely exit. As such, no compensation can be considered enough. In such cases, obtaining specific performance of the contract compelling the promoters and/ or the company to honor their obligations to provide an exit under the investment agreement may be the more appropriate remedy to seek.

One thing which should be carefully captured in the investment agreement to achieve this is that non-performance of the exit obligation should be stated to be a repudiatory/ material breach. As, explained above, the option of rescission can be available for a breach of an obligation only if the obligation is material in nature i.e. the breach is repudiatory in nature. Thus, making it clear in the investment agreement would reduce the scope for debate at the time of a dispute.

Also, it is important to be mindful that specific performance is granted only is cases where compensation is not an adequate remedy.[16] Hence seeking compensation/ damages in alternate to specific performance may prove fatal.

It is also important to bear in mind that specific performance is granted only for executory contracts and not concluded/ executed contracts.[17] Concluded/ executed contracts are those in which both parties have discharged all their obligations.[18] Thus under a share purchase or shareholders agreement after closing the contract would generally be a concluded contract. Hence, it is important to cover exit options/obligations under a shareholder's agreement and a positive covenant from the target company and/ or promoters.

Additionally, specific performance is an equitable relief and thus it is important to be mindful that any clause under the investment agreement which restrict equitable reliefs should be absolutely avoided.

16. Section 10 of the Specific Relief Act, 1963 (**"SRA"**)
17. Halsbury's Laws of England, Vol. 31. 327 (1938, 2nd Edition, 1938).
18. Pollock & Mulla, Indian Contract and Specific Relief Act 444 (14th Edition, 2012)

IV. Rescission

While strategizing the exit one has to keep in mind that "Specific Performance" as a remedy is available only in limited situations; it is not a matter of right and is granted:

i. in cases for non-performance in which compensation will not be an adequate remedy [19]

ii. where enforcement of the terms of the contract is not difficult, expensive or ineffective[20]

iii. where the plaintiff's conduct does not disentitle him from seeking the equitable relief.[21]

iv. at the discretion of the court, to be exercised on the basis of sound principles[22]

Thus it is appropriate in such cases to seek certain alternate remedies. The Specific Relief Act, 1963 ("**SRA**"), which is a specialized legislation dealing with specific performance of a contract under law, specifically provides the claimant a right to seek rescission of a contract in alternate to specific performance of a contract.[23] As, explained in the section above, while seeking rescission, parties are expected to return the benefit obtained under a contract, hence the effect of the alternate relief of rescission would be returning the investment instrument and receiving the investment amount.

Thus an exit can not only be achieved through seeking specific performance of the contract but also by seeking to rescind the investment agreement. Though the price would only be the principle investment amount, Indian law also recognizes the right of a party to receive reasonable interest.[24] This is because, as discussed above, at the time of rescission parties are put into a position they were in prior to the investment agreement.[25] This would require the target company and/ or the promoters to compensate the investor for the lost interest over the investment period. The rate of interest awarded is left to the court's/ arbitral tribunal's discretion and subjected to a test of reasonability.[26] In the past, depending on facts and circumstances of cases the Indian Supreme Court has held that an interest rate between 12 to 21% is reasonable. Thus, one can factor interest between these ranges as additional return over the principle investment.

In situations where due to regulatory changes and uncertainty the exit mechanism has become difficult to enforce, rescission by itself can prove an appropriate remedy to achieve exit.

V. Damages

Unlike in cases of specific performance, damages/ compensation can be sought in alternate to rescission of contracts or as a standalone for every breach of a contract, whether material or not.[27] Also, if specific performance does not compensate for the loss already suffered, a relief of damage is available to seek restitution for losses caused *de hors* the relief of specific performance.[28]

Damages under Indian Law are governed by common law principles and Section 73 and 74 of the Contract Act. Under Section 73 of

19. Pollock & Mulla, Indian Contract and Specific Relief Act 1898 (14th Edition, 2012)
20. Section 14 of SRA
21. Section 16 of SRA
22. Section 20 of SRA
23. Section 29 of SRA
24. Pollock & Mulla, Indian Contract and Specific Relief Act 1250 (14th Edition, 2012)
25. Section 64 r/w Section 65 of the Contract Act, Section 30 of SRA
26. Pollock & Mulla, Indian Contract and Specific Relief Act 1181 (14th Edition, 2012)
27. Section 73 of the Contract
28. Section 21(3) of SRA

the Contact Act, when a contract has been broken, the investor is entitled to receive compensation for any loss caused which they considered a likely result from the breach of the investment agreement at the time of entering the transaction. Thus, in deciding whether damage claimed is too remote, the test is whether the damage is such as must have been in the contemplation of parties as being a possible result of the breach. If it is, then it cannot be regarded as remote.[29] Foreseeability is seen as at the time of making the contract.[30] Thus, in case an investor anticipates any special circumstances which may be affected by breach of the investor agreements, it is important to communicate the same to the target company at the time of investment.[31] It may also be useful to document an internal risk report at the time of investment, which can be shared by the target and used as evidence of knowledge of potential losses.

In addition, the investor can also claim damages for the losses arising after the breach like liability from third parties like co-investors, limited partners.[32] In cases where non-performance of an exit obligation causes the investor to sell the investment to a third party at a lower price, the difference in price obtained can also be regarded as damage.

This Section is to be read with Section 74 of the Contract Act, which deals with penalty stipulated in the contract, inter alia provides that when a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, the party complaining of breach is entitled, whether or not actual loss is proved to have been caused, thereby to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named. Section 74 emphasizes that in case of breach of contract, the party complaining of the breach is entitled to receive reasonable compensation whether or not actual loss is proved to have been caused by such breach. Therefore, the emphasis is on reasonable compensation. If the compensation named in the contract is by way of penalty, consideration would be different and the party is only entitled to reasonable compensation for the loss suffered. But if the compensation named in the contract for such breach is genuine pre- estimate of loss which the parties knew when they made the contract to be likely to result from the breach of it, there is no question of proving such loss and such party is not required to lead evidence to prove actual loss suffered by him.[33] Thus, during negotiations it may be useful to include genuine pre- estimate of losses in the investment agreement for certain breaches.

VI. Indemnity

An agreement of indemnity, as a concept developed under common law, is an agreement wherein the promisor, promises to hold the promisee harmless from loss caused by events or accidents which do not or may not depend on the conduct of any person or from liability for something done by the promisee at the request of the promisor. Section 124 of the Contract Act defines a "Contract of Indemnity" as a contract, by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person. Thus, obligations of the promoters and/ or the company can be backed by negotiating an indemnity into the agreement for non-performance.

As such the scope of "Indemnity" as a concept developed under the common law, is much wider in its scope and application than the scope of "Indemnity" as defined under Section 124 of the Contract Act. "Indemnity"

29. *Hadley v. Baxendale*, (1854) 9 Exch 341
30. *Jackson v. Royal Bank of Scotland*, [2005] UKHL 3.
31. *Chitty on Contracts*, 28th edn., para 27-051 at 1296.
32. *Borries v. Hutchinson*, (1865) 18 CBNS 445.
33. *ONGC v. Saw Pipes*, AIR 2003 SC 2629

as developed in common law, includes losses caused by events or accidents which may not depend on the conduct of any person and therefore includes losses due to accident or events which have not been caused by the indemnifier or any other person. Thus, even non-promoter subsidiaries and individuals can be made parties to an investment agreement as an indemnifying party.

But it should be kept in mind that a right to indemnity is distinguished from the right to damages arising from a breach of a contract. While the right of indemnity is given by the original contract, the right to damages arises in consequence of breach of that contract.[34] Where a contract contains an indemnity clause and does not exclude the right to damages, the investors have to choose between the remedies as both cannot be simultaneously adopted. However, in an investor agreement there are multi-parties which are jointly and severally liable for every breach. In such a situation, it may be advisable to limit the claim of damage to one or two such entities and lodge a separate claim of indemnity against the other entities. This will help the investor to expedite the claim for recovery under two simultaneous actions.

The question which remains unanswered under Indian Law, and has received divergent legal opinions from different courts of law, is with regards to commencement and extent of liability. One view is that when a person contracts to indemnify another, the latter may compel the indemnifier to place him in a position to meet the liability that may be cast upon him, without waiting until the indemnity holder has actually discharged it. The other view to the contrary is that the indemnity holder does not become liable until the indemnified has incurred actual loss.[35] Thus making it important to negotiate the mechanism for commencement of indemnity and the extent of liability, and capture the same in the investment agreement.

34. *Krishnaswami Iyer v. Thahia Raghaviah Chetty*, AIR 1928 Mad 1135
35. Pollock & Mulla, Indian Contract and Specific Relief Act 1343 (14th Edition, 2012)

4. Inability to Maintain Transparent Governance

Investors put their money into a company on certain conditions. The first of them is that the business in which they invests shall be limited to certain definite objects. The second is that the bussiness shall be carried on by certain persons elected in a specified way. The third is that the business shall be conducted in accordance with certain principles of commercial administration defined in the statute, which provide some guarantee of commercial probity and efficiency. If the investors find that these conditions, or some of them are deliberately and consistently violated and set aside by the actions of the promoter and/or other officials of the company who wield an overwhelming voting power or excise control on the day to day affairs of the company, and if these actions result in the extrication of their rights as shareholders, and they are deprived of the ordinary facilities which compliance with the companies acts would provide them with, then the investor should seek relief for oppression and mismanagement available under Sections 397 to 408 of the erstwhile Companies Act and now under Sections 241 to 244 & 246 of the Companies Act, 2013, de hors the investment agreement.

I. Action for Oppression and Mismanagement

'Oppressive' means "burdensome, harsh and wrongful." It will ordinarily be an act of oppression on an investor if he is deprived of his privilege and rights. Such an act will undoubtedly be harsh, burdensome and wrongful and will necessarily be an act of oppression to the member concerned. The element of lack of probity of fair dealing to a member in matters of his proprietary rights as a shareholder is also oppression. Even if the oppression was of a short duration and of a singular conduct, if its effects persisted indefinitely it would be an act of oppression. Thus actions in disregard of the shareholder's rights like appointment of directors, prior consent, sufficient disclosure and information, including reserved item rights, could be classified as acts of oppression.

Mismanagement occurs when the affairs of the company are conducted in a manner prejudicial to the interests of the company. Over the years the following acts have been held as amounting to mismanagement:-

- ☒ Where there is serious infighting between directors.
- ☒ Where Board of Directors is not legal and the illegality is being continued.
- ☒ Where bank account(s) was/were operated by unauthorised person(s).
- ☒ Where directors take no serious action to recover amounts embezzled.
- ☒ Continuation in office after expiry of term of directors.
- ☒ Sale of assets at low price and without compliance with the companies act.
- ☒ Violation of Memorandum.
- ☒ Violation of statutory provisions and those of Articles.
- ☒ Company doomed to trade unprofitably.

In such cases, though certain obligations under the investment agreements may have been breached they may not have amounted to repudiatory or specifically performable breaches. Hence, remedies for oppression and mismanagement under the companies act may be a more suitable course of action because under the erstwhile companies law the powers

of the Company Law Board ("**CLB**") in cases of oppression and mismanagement are very wide.[36] These include:-

i. the regulation of the conduct of the company's affairs in future;

ii. the purchase of the shares or interests of any members of the company by other members thereof or by the company;

iii. in the case of a purchase of its shares by the company as aforesaid, the consequent reduction of its share capital;

iv. the termination, setting aside or modification of any agreement, howsoever arrived at, between the company on the one hand, and any of the following persons, on the other namely:-

- the managing director;
- any other director;
- the manager;

Further the powers extended to the bankruptcy court (winding up court) under sections 539 to 544 of the erstwhile act have been extended to the CLB for proceedings under sections 397 or 398 of the erstwhile act by virtue of section 406 of the erstwhile act. Similar powers, though not yet in force, are available under Section 336 to 341 of the Companies Act, 2013. They are as follows:

i. Sections 539 and 540 of the erstwhile act are essentially penal provisions relating to falsification and fraud respectively. Whilst section 539 of the erstwhile act can be applied to companies in respect of which an *application* under section 539 and 540 of the erstwhile act have been made, section 540 of the erstwhile act deals with companies in respect of which the *CLB subsequently makes an order under sections 397 or 398.*

ii. Section 541 of the erstwhile act deals with the liability where proper books of account were not kept when an application has been made to the CLB under section 397 or 398 of the erstwhile act.

iii. Section 542 of the erstwhile act confers discretionary power on the CLB to make a declaration of liability for fraudulent conduct of business.

iv. Section 543 of the erstwhile act deals with the powers of the CLB to investigate into the conduct of directors, managing agents, secretaries etc. Section 544 of the erstwhile act further extends the power of the CLB to make a declaration under section 542 or an order under section 543 which has been passed in respect of a firm or body corporate to a partner in such firm or to a director in such body corporate.

Thus, in cases where there is oppression and/or mismanagement and the target companies and its promoters exploit their majority and/or control to act against the interest of the Fund with an attempt to deprive it of its rights and privilege guaranteed under the investor agreement, and many a times replicated in the Articles of Association of the target company, exploring remedies under the statutory provisions of the companies act is more suitable. In cases of gross oppression and/or mismanagement the CLB has the power to even provide an exit to the aggrieved investors.

In situations where the oppression and mismanagement has caused substantial depreciation in the value of the investment, in addition to rights available before the CLB, damages can be sought in a civil action before a court or an arbitral tribunal. The diminution in the value of shares in the company is by definition a personal loss and not a corporate loss. Shares are the property of the shareholder and not the company, and if he suffers loss as a result of an actionable wrong done to him, then *prima facie* he alone can sue and the company cannot. Although a share is an identifiable piece of property which belongs to

36. Section 402 of the Companies Act, 1956

the shareholder and has an ascertainable value, it also represents a proportionate part of the company's net assets, and if these are depleted the diminution in its assets will be reflected in the diminution in the value of the shares. The correspondence may not be exact, especially in the case of a company whose shares are publicly traded, since their value depends on market sentiment. But in the case of a private company, the correspondence is exact. Thus, compensation for the depreciation in value of shares may be achievable in certain cases of oppression and mismanagement

II. Actions for Siphoning of Assets

In cases involving siphoning of assets through unauthorized bank accounts, related party supplier and customer contracts, related party loans and deposits, etc. remedies such as full disclosure and access to companies accounts, forensic investigation of accounts, return of siphoned assets, personal liability of malefactor directors and members are also provided for both under the erstwhile companies act and the Companies Act, 2013.

Under S. 235(2) of the erstwhile companies act, an application can be made to the CLB seeking a declaration that 'the affairs of a company ought to be investigated by an inspector or inspectors'. Investigation into the affairs of a company means investigation of all its business affairs – profits and losses, assets including goodwill, contracts and transactions, investments and other property interests and control of subsidiary companies as well.[37] Though not yet available, similar reliefs are provided under Section 210 of the Companies Act, 2013.

Such a declaration can be made by the CLB upon receiving an application made by 'not less than two hundred members or from members holding not less than one-tenth of the total voting power' in case of a company with a share capital.[38] The CLB though not obliged to direct appointment of investigators has the discretion to direct investigation in cases which it deems fit.[39] The CLB is required to afford the parties an opportunity of being heard upon receiving such an application. Thereafter, if the CLB makes a declaration that the affairs of the company ought to be investigated by an inspector or inspectors, the Central Government is mandatorily required to appoint one or more competent persons as investigators.[40]

It has been held that in cases where there are allegations of siphoning off funds, fabrication of resolutions, non-compliance with CLB orders directing disclosure of information about affairs of the company to shareholders and violation of provisions of the Act and articles of association, the CLB may legitimately declare that the affairs of the company ought to be investigated.[41] An investigation may also be ordered when directors of a company areremoved and the assets of the company sold off.[42] It is pertinent to note, however, that an investigation under Section 235 may only be ordered when public interest or shareholders' interests are involved; it must not be ordered merely on the basis of shareholders' dissatisfaction.[43]

Further under Section 237 of the erstwhile companies act the CLB also has power to order an investigation where there are circumstances suggesting--

i. that the business of the company is being conducted with intent to defraud its

37. *R. v. Board of Trade, Ex parte, St. Martin Preserving Co. Ltd.*, (1964) 2 All. E.R. 561; Ramaiya, 3240.
38. Section 235 (2) (a) of the Act.
39. *Mool Chand Gupta v. Jagannath Gupta & Co.*, AIR 1979 SC 1038.
40. Section 235 (2) of the Act; RAMAIYA, 3239.
41. *Citicorp International Finance Corp. v. Systems America (India) Ltd.*, (2008) 141 Com Cases 954.
42. *Suresh Arora v. Grevlon Textile Mills P. Ltd.*, (2008) 142 Com Cases 963.
43. *Binod Kumar Kasera v. Nandlal & Sons Tea Industries P. Ltd.*, (2010) 153 Com Cases 184.

creditors, members or any other persons, or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive of any of its members, or that the company was formed for any fraudulent or unlawful purpose;

ii. that persons concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members; or

iii. that the members of the company have not been given all the information with respect to its affairs which they might reasonably expect.

Similar powers, though not yet in force, are available under Section 213 of the Companies Act, 2013.

III. Nominee Directors Actions

In cases where the target fails to maintain transparent governance, it becomes critical for the nominee directors of the Fund to take steps with prudence. This is essential to avoid defenses of acquiescence by the target and also to avoid liability under statutory provisions. In such cases it is also essential for the directors to balance between their duties towards the Fund and fiduciary duties towards the target company. The do's and don'ts can be listed as follows:

A. Board Meetings

It's common for information regarding lack of transparent governance to be brought to the knowledge of the investor, through an on ground advisory team which would include the nominee director. In such situations, it is reactionary for the nominee director to use his board seat to voice the concerns of the Fund during a board meeting. Instead it is advisable for the investor to directly address concerns to the board, which the nominee director may then press for deliberation, rather than the nominee director raising these issues himself.

Further, while making recommendations and tabling resolution, the nominee director should bear in mind his fiduciary obligations towards the target company and should refrain from making suggestions, which though in the favor of the investor, are against the interest of the target company.

B.Investigation & Forensic Audit

In situations when improprieties are brought to the knowledge of the nominee director it becomes extremely important for him to act prudently and insist on having investigations and forensic audits to receive expert advice on the alleged improprieties. This helps the nominee director establish good faith on his part and help him discharge his fiduciary duties towards the target company.

Also, at such times the nominee director should refrain from approving any radical operating budgets and balance sheets. This ensures elimination of personal liability of the nominee director for wrong doings possibly alleged by the promoters and promoter group.

C. Independent Advisors

It is essential for the nominee director to insist on separate legal advisors for the board and the target company from that of the investor and promoters. This ensures a balance of fiduciary obligations and dispels the notion of investor control over actions taken by nominee director.

D. Resignation

Only after attempting to take sufficient steps, as above, should a nominee director resign from the target company. This helps the nominee director to ensure discharge of his fiduciary obligations towards the target

company, to the extent possible and under his control.

IV. Interplay Between CLB Action and Arbitration

In cases of lack of transparent governance, it also becomes important to understand the interplay between the CLB action and rights available under the arbitration agreement contained in the investment agreements. Both actions can be used harmoniously to expedite investor actions to tackle improprieties.

As discussed above, the CLB has wider powers than an arbitral tribunal and hence it's important to seek only those reliefs before CLB which an arbitrator cannot grant. If this is not ensured, the promoters may use the arbitration clause to stall the CLB action on jurisdictional objections. Additionally, the evidence obtained through CLB orders of investigations and disclosure can provide sufficient arsenal to achieve exit through the arbitration route.

Thus, an inclusive strategy to issues of lack of transparent governance would include taking appropriate board actions, while balancing between the rights available before CLB and those provided for under the investment agreement in the form of an arbitration agreement.

5. Disputes With Managers and Advisors

The disputes discussed above are not limited between investors and the target. Many times, investors face similar disputes with their own fund managers and advisors. Though the law applicable to agreements between the investor and manager and between investor and advisor is likely to be a foreign law, strategies in handling the disputes remain the same.

Similarly, General Partners, who also act as managers and advisors through various entities, should be mindful that lack of prudent action or inaction, misrepresentation, and incomplete disclosure, if not brought to the attention of the limited partners in time could lead to similar liabilities as those a target would face in such situations.

6. Conclusion

Thus, while strategizing and tackling disputes investors have to examine the rights available to them in light of obstacles which are bound to arise while litigating against an India Party with overarching aim to safeguard the "interests" which the investors seeks to secure through the dispute resolution process. A silo approach adopting "rights" based strategy disregarding the inherent obstacles or the "interest" of the clients would lead to the litigation becoming burdensome and eventually a futile process costing thousands of dollars in legal fees for the years of litigation without achieving the desired exit at the desired time.

The correct approach towards tackling disputes during the life cycle of the fund is to examine the entire cycle of the exit, including the dispute notice stage, the dispute resolution stage and the execution stage at the time of formulating a "pre-dispute strategy", like one would examine the cycle of the investment at the time of entry and aim to achieve the most commercially viable exit in the least possible time bringing a harmony between the expectations in the "board room" and challenges of the "court room".

Nishith Desai Associates

About NDA

Nishith Desai Associates (NDA) is a research based international law firm with offices in Mumbai, Bangalore, Palo Alto (Silicon Valley), Singapore, New Delhi, Munich and New York. We provide strategic legal, regulatory, and tax advice coupled with industry expertise in an integrated manner.

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Equally passionate about philanthropy, social sector and start ups, our role includes innovation and strategic advice in futuristic areas of law such as those relating to Bitcoins (block chain), Internet of Things (IOT), Privatization of Outer Space, Drones, Robotics, Virtual Reality, Med-Tech and Medical Devices and Nanotechnology.

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Research is the DNA of NDA. In early 1980s, our firm emerged from an extensive, and then pioneering, research by Nishith M. Desai on the taxation of cross-border transactions. The research book written by him provided the foundation for our international tax practice. Since then, we have relied upon research to be the cornerstone of our practice development. Today, research is fully ingrained in the firm's culture.

Research has offered us the way to create thought leadership in various areas of law and public policy. Through research, we discover new thinking, approaches, skills, reflections on jurisprudence, and ultimately deliver superior value to our clients.

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