SHADOW CONTROL IN INDIAN PRIVATE EQUITY: WHEN PROTECTIVE RIGHTS BECOME CONTROL

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ABSTRACT

The Indian private equity and venture capital market has seen exponential growth in deal frequency. However, there exists a regulatory vacuum in terms of regulating these investments. Under Indian law, control has been defined in 4 different statutes, namely the Companies Act 2013, the Competition Act 2002, SEBI SAST regulations and FEMA NDI Rules 2019. A minority investors shareholders' agreement generally includes clauses like affirmative voting rights, quorum requirements, the right to appoint nominee directors, information rights and exit rights disguised as protective rights, and under the current Indian law there is no threshold regarding when these rights cross the boundary from protection to control. The paper analysed 10 shareholders' agreements determining what protective rights handover control to the minority investors and what harms it causes such as exit timing distortions, structural deadlock and inability to restructure the company. The paper suggests both contractual and regulatory reforms like reasoned vetoes with defined fallbacks, governance schedules at signing and codifying protective rights under the Takeover Regulations definition 2(1)(e).

1. Introduction

India's Private Equity and Venture Capital ecosystem has significantly evolved over the past decade, with India attracting US$ 60.7 billion across 1,475 PE/VC deals in 2025, the highest deal count ever recorded.[1] H1 2026 recorded a slowdown that EY attributes to geopolitical tensions, valuation gaps and rupee depreciation.[2] Even against this cyclical slowdown, the installed base of PE/VC-backed Indian companies continues to grow, and the governance arrangements negotiated at the point of investment continue to shape how those companies operate. In Indian law control has been explicitly defined in four frameworks: the Companies Act[3], the SAST Regulations,[4] the Competition Act,[5] and the FEMA NDI Rules.[6] Despite the four definitions being almost identical to one another, each of them functions within a different regulatory context. None of the definitions set out a uniform test of when control has been established. Moreover, there is no common consequence of finding the existence of the control as well. This is what gives rise to "shadow control", which is understood as the material influence that the minority investors exercise through the combination of their contractual governance rights. Such contractual governance rights are a usual element of the shareholders' agreements in India. These rights include the right to appoint nominee directors, reserved matters, the quorum conditions, information rights, and liquidation preference on exit.

Each right has a protective purpose and on several occasions these rights have been found to be sufficient as protective rights for the minority position rather than constituting control. However, each right is not separately included in the Indian PE/VC shareholders' agreement (SHA). These rights are included in a bundle of rights, and the protective rationale of every separate right does not hold when the package is analyzed as a whole. Each regulatory framework defines the concept of control in its own way, however none of them addresses the issue raised by the notion of shadow control. Shadow control operates beyond the reach of the existing regulatory frameworks, causing clear problems for the operation of the framework and

[1] EY & Indian Venture and Alternate Capital Association, PE/VC Agenda: India Trendbook 2026 (Mar. 2026), available at https://www.ey.com/en_in/newsroom/2026/03/india-s-pe-vc-industry-staying-on-the-front-foot-despite-global-headwinds-ey-ivca-trendbook-2026 (last visited Oct. 29, 2026).
[2] Id.
[3] The Companies Act, 2013, s. 2(27), [hereinafter "Companies Act, 2013"].
[4] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, reg. 2(1)(e), Gazette of India, pt. III sec. 4 (Sept. 23, 2011) [hereinafter "SAST Regulations, 2011"].
[5] The Competition Act, 2002, Explanation (a) to s. 5, [hereinafter "Competition Act, 2002"], as amended by the Competition (Amendment) Act, 2023, No. 9 of 2023.
[6] Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, r. 2(da), G.S.R. 796(E), Gazette of India, pt. II sec. 3(i) (Oct. 17, 2019) [hereinafter "FEMA NDI Rules, 2019"].

structure, and requires targeted reform in the areas of regulation and contracts. The analysis in this paper is based on careful examination of the Indian legal frameworks and relevant judicial authority on control, the obligations of the nominee directors and the oppression relief, empirical review of ten shareholders' agreements executed in Indian PE/VC deals, and comparative reference to the authority in In re Trados Inc. Shareholder Litigation.

2.The Anatomy of Contractual Governance

2.1.Reserved Matters/Veto/Affirmative Voting Rights

Private Equity and Venture Capital firms typically invest as minority shareholders in companies and therefore cannot direct the functioning of such companies solely through voting power. Shareholder agreements consequently create governance mechanisms that require investor consent to undertake some special corporate actions. These provisions can be drafted as reserved matters, veto rights or affirmative consent matters. Although the terminology might be different, the commercial functions are substantially similar, i.e., allocating decision-making power between the investors (private equity & venture capital firms) and the promoters of the company.

Upon clause-by-clause analysis of 10 shareholder agreements, the number of reserved matters ranged from 11 to 25. Despite the difference in the drafting styles, transaction size and structure, the reserved matters are repetitively concentrated around 3 buckets, which are Finances, Governance and Strategic Decisions. Unlike the Companies Act 2013, where the shareholder approval is required for a relatively narrow set of corporate actions such as asset disposal, merger or amalgamation, borrowing funds that are more than the total paid-up share capital of the company,[7] the shareholder agreements reviewed included matters like borrowing, capital expenditure, annual budget, appointment of key managerial person, entry into new business lines, and amending the constitutional documents of the company. Although the precise combination varied between the agreements. The current mapping of the 10 shareholder agreements shows budget approval, borrowing, capital expenditure, amendment of constitutional documents, and litigation consent appeared in all 10 agreements. While new business lines, dividends, appointments of key managerial personnel and the sale of assets appeared in 9 agreements mapped.

[7] Companies Act, 2013, *supra* note 3, s. 180.

However, the agreements do not transfer the routine management of the company to the investors. The day-to-day functioning of the company remains with the promoters and the board of directors, the reserved matters principally allow the investors to prevent certain corporate actions from being taken without their approval, therefore acting as a negative control mechanism. The same approach was adopted by the Competition Commission of India in the case of *Jet Airways (India) and Etihad Airways PJSC (Combination Registration No. C-2013/05/122, decided 12 November 2013).*[8] The Competition Commission of India did not assess Etihad's 24% ownership alone but in aggregate with the arrangements in the "investment agreement, shareholder agreement, and commercial cooperation agreements" and the Board nomination rights. These agreements were treated as a composite combination where the Commission established Etihad's joint control over Jet Airways (India), particularly over its operations and assets.[9]

Similarly, in the case of *ChrysCapital/Intas Pharmaceuticals (Combination Registration No. C-2020/04/741, decided 30 April 2020),*[10] where the competition commission looked past the shareholding percentage in the 3 holding companies and at board representation, information rights, veto over mergers and acquisitions, new business lines and amending the charter documents. The commission concluded that these rights have given ChrysCapital material influence over Intas's competitors, making Chryscapital surrender certain veto powers and its power to appoint nominee directors.[11]

The significance of examining these rights collectively will be further considered when reserved matters are assessed alongside board, quorum, information rights and exit rights.

2.2.Board, Quorum and the two-layer architecture

The board provisions in the SHA provide the investor with a continuing position in the decision-making process of the company. Unlike the reserved matters that operate when a specific corporate action has to be undertaken, the investor may obtain a nominee seat, quorum

[8] J*et Airways (India) Ltd. and Etihad Airways PJSC*, Combination Registration No. C-2013/05/122, Competition Commission of India (decided Nov. 12, 2013), available at https://www.cci.gov.in/combination/order/details/order/818/4/orders-section31

[9] *Id.* at paras. 15–17.

[10] *ChrysCapital and Intas Pharmaceuticals Ltd.*, Combination Registration No. C-2020/04/741, Competition Commission of India (decided Apr. 30, 2020), available at https://www.cci.gov.in/combination/order/details/order/1064/0/orders-section31

[11] Id.

rights, observer rights, committee representation, and access to board papers.

The empirical analysis of all 10 SHAs shows that investor nominee director rights, the right to replace nominee directors, observer rights, and observer board paper rights appear in all 10 agreements, while chairperson appointment rights appear in 8 out of 10 agreements, giving the investors a seat on the board and a right to vote in the company's strategic decisions. Quorum commercially does something different by making the investor's participation a necessity for transacting the business. The same empirical analysis shows quorum requirements, quorum waivers and investor committee representation were present in all 10 shareholders' agreements.

Subject to the articles of association of the investee company, Section 161(3) of the Companies act 2013 permits the board to appoint a person nominated (nominee director) under the agreements,[12] but the appointment does not supersede the statutory duties of the nominee directors. Although section 166 requires the nominee directors to act in good faith, using the best of their judgement, knowledge, skill, and diligence.[13] Barring the directors from any direct or indirect conflict of interest.

In the case of *M/s Subhkam Ventures Private Limited vs SEBI,* the Securities Appellate Tribunal, based on the facts, held that Subhkam's nominee director rights, quorum presence and other protective provisions did not constitute control.[14] The provisions are protective in nature and are not directing or compelling the company to do a specific course of action. The Supreme Court later disposed of the case in light of changed circumstances, ordering that the SAT's decision not to be treated as a precedent, keeping the question of law open.[15]

2.3.Information rights

Private Equity and Venture Capital firms at times want to go beyond periodic financial statements by requiring management reporting and board papers that at times are not available with shareholders, giving the investors access to the financial and operational aspects of the company and helping the investors monitor it. The analysis of the 10 shareholders' agreements shows that annual and quarterly financial statements, monthly Management Information

[12] Companies Act, 2013, *supra* note 3, s. 161(3).
[13] *Id.* s. 166.
[14] *M/s Subhkam Ventures Pvt. Ltd. v. SEBI*, Appeal No. 8 of 2009, Securities Appellate Tribunal (decided Jan. 15, 2010), available at https://www.sebi.gov.in/satorders/subhkamventures.pdf
[15] *SEBI v. Subhkam Ventures (P) Ltd.*, Civil Appeal No. 3371 of 2010, Supreme Court of India (order dated Nov. 16, 2011).

System (MIS), budget reporting, access to board agendas, inspection rights and annual audited financial statements are present in all 10 agreements. The agreements also require the promoters to report all the litigation, regulatory and governmental investigations to the investors. Eight of the ten SHAs have given the power to the investors for inspection rights of the assets of the investee company. All of the 10 agreements have a reporting period for financial statements. MIS are to be provided within 14 days of the end of the month, quarterly financial statements are to be provided within 30 days of the end of the quarter, whereas the annual audited financial statements are required within 90 days of financial year's end. The Companies Act in contrast, establishes a minimum baseline on reporting and inspection rights available to the shareholders.

Shareholders' agreements also place conditions on the continuation of information rights. Nine out of ten shareholders' agreements specified an equity or preference shareholding threshold ranging from 4% to 7%, dropping below which would cause the information rights to fall away automatically. Using this information, the investors decide when a reserved matter is to be challenged, a board right is to be exercised or exit rights to be considered.

2.4.Exit rights: Governance beyond investment

The SHA also governs the exit rights of the investors, where the drag-along rights can compel the other shareholders to sell their shares; the put option can provide the investors with a contractual mechanism to require exit on investor's specified terms; the liquidation preferences ensures that the investors are prioritised while the exit proceeds are being distributed. The mapping of the 10 shareholders' agreements shows that the tag-along rights appear in 8 out of 10 agreements, while drag-along rights are present in the remaining 2. The tag-along rights allow the minority investors to participate in the sale of another shareholder's shares on the same price; the drag-along rights contractually compel the other shareholders to participate in the sale of shares once the agreed conditions in the shareholders' agreements are satisfied. A liquidation preferences clause was standard across all agreements with multiples of 1x, 1.4x or 1.5x varying across agreements.

All these mechanisms add another layer of protection to the investor's contractual position. Drag-along and tag-along rights affect the circumstances in which the exit happens; liquidation preferences ensure that the investors are prioritised when the exit proceeds are being distributed. These clauses, read alongside reserved matters, board nomination rights, quorum

rights and information rights, show how a minority investor's contractual rights can extend far beyond the rights that are attached to their shareholding in the investee company.

2.5.Aggregate effect

The previous subsections examine the contractual mechanisms that help investors participate in the governance of the company they invested in. Their significance becomes clearer when these rights are assessed together. A minority investor can hold reserved rights over certain corporate acts, board representation rights, quorum rights, management information rights and contractual rights that will concern his exit from the company. The position these rights put investors in should not be assessed by looking at these rights independently. Across the 10 SHAs analysed, investor approval is required for budget, borrowing, capital expenditure, litigation consent and amendments to constitutional documents, while 9 out of 10 agreements require investor approval for new business lines, appointment of key managerial personnel and asset sale. Investor nominee director rights, replacement rights, observer rights and board paper access are present in all 10 SHAs. All 10 SHAs also provide management information, inspection rights and reporting concerning litigation, regulatory and material events, extending a step beyond financial statements. Exit protection makes another layer where liquidation preferences are standard across all shareholders' agreements. Tag-along rights appear in 8, while the other 2 have drag-along rights. Taken together, these rights extend the investors position from allowing certain corporate matters and preventing specific decisions to participating in the decision-making of the company, having advance knowledge of its direction and protecting the economic value of the investment amount upon exit.

The Competition Commission's approach in the case of ChrysCapital and Intas Pharmaceuticals. The shareholding and the rights that are attached to it determine whether an acquisition is merely an investment or confers control or material influence. The Commission examined the board appointment powers, veto rights and information access rights together and not in isolation and found that the investors can not unilaterally force or block the decisions of the companies they invested in but, with the same set of rights, can materially influence their strategic affairs, and the investors are likely to follow the same strategy with ChrysCapital and Intas.

The problem in the existing framework is not that it fails to recognise these contractual rights. Section 2(27) of the Companies Act 2013 and 2(1)(e) of the SAST Regulations explicitly

recognise control arising from SHAs.[16] The problem lies in when a collection of rights that are individually considered as protective rights, taken in aggregate, crosses a boundary from protective rights into what law would call control.

3.Definitions of Control. A comparison.

Indian law does not use a single text in determining control. There are four different frameworks where it is defined. Section 2(27) of the Companies Act, 2013; Regulation 2(1)(e) of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011; explanation (a) to section 5 of the Competition Act, 2002; and rule 2(da) of the Foreign Exchange Management Act (Non-Debt Instruments Rules) 2019. The first, second and fourth definitions use substantially aligned language. The FEMA (NDI) 2019 Rules were amended in 2024, expressly providing that the term "control" carries the same meaning as under the Companies Act, 2013.[17] The Competition Act sets the threshold at "material influence" over the management and affairs of the company, stating it as the lowest threshold the CCI may find control. The difference between the four definitions is not the wording but what follows once control is found.

Section 2(27) of the Companies Act, 2013, contains the broadest definition of contractual control. Investors get the right to directly or indirectly appoint the majority of directors, control the management or policy decisions of the company through shareholding, shareholders' agreements, management rights, voting agreements or in "any other manner". The problem is not how the definition is worded, but that there is no law defining what amount of minority rights, once accumulated, will cross into control.

SAST is stricter in its consequences for the same broad concept. Regulation 2(1)(e) defines control almost identically to the Companies Act. Regulation 3 sets a 25% threshold for triggering an open offer. Regulation 4 goes a step ahead, triggering an open offer regardless of the percentage of shares acquired if the investors acquire control.[18] For a minority investor, investing in a listed company increases the consequences in a way it might not in the Companies Act 2013. The Securities Appellate Tribunal in the case of *M/s Subhkam Ventures Private Limited vs SEBI* said the rights of the investors were protective in nature, as they gave

[16] Companies Act, 2013, *supra* note 3, s. 2(27); SAST Regulations, 2011, *supra* note 4, reg. 2(1)(e).
[17] Companies Act, 2013, *supra* note 3, s. 2(27); SAST Regulations, 2011, *supra* note 4, reg. 2(1)(e).
[18] SAST Regulations, 2011, *supra* note 4, regs. 3 & 4.

the investors the right to stop specific actions of the company rather than giving the investors the right to dictate the actions of the company.[19] The Supreme Court in the case left the question open, directing that SAT's judgement shall not be treated as a precedent.[20] SEBI in 2016 returned to the topic, considering the bright-line test, separating control and protective rights but retaining a case-by-case approach in the same.[21] In the case of *Kamat Hotels (India) Limited*, SEBI WTM Order No. WTM/GM/EFD/DRAIII/20/MAR/2017, dated 31st March 2017[22]. The same approach was taken by SEBI, where it examined the quorum rights and affirmative consent rights, along with the other rights in the contract as a whole.

Following the 2023 amendment in the Competition Act 2002, the bar has been set lower under explanation (a) of section 5 of the Act, stating the ability to exercise material influence on affairs and management of the company or its commercial decisions, treating it as a floor of control. *Jet Airways (India) and Etihad Airways PJSC (Combination Registration No. C-2013/05/122, decided 12 November 2013)* illustrates what this looks like in practice.[23] While assessing the case, the Commission looked at the investment agreement, the commercial cooperation agreement, and board rights together rather than looking at the 24% shareholding in isolation and the rights attached to it, giving it joint control in Jet India's assets and operations. But this test operates in a much narrower framework than it appears. Section 5 asks when a deal is actually a combination, and section 6 asks when that combination has to be reported to the commission.[24] Material influence is a rule that does not judge the day-to-day status of the minority shareholders' corporate status. It does one job in one place and nothing more.

Three of the four definitions of 'control' almost use the same words, apart from the Competition Act 2002. The act emphasises how control, including 'material influence', has been acquired in a transaction by a private equity or venture capital investor falling within the competition laws. An investor may hold the same reserved matters rights, quorum rights, and information

[19] *Subhkam Ventures v. SEBI*, *supra* note 14.
[20] *SEBI v. Subhkam Ventures (P) Ltd.*, *supra* note 15.
[21] Securities and Exchange Board of India, *Discussion Paper on "Brightline Tests for Acquisition of 'Control' under SEBI Takeover Regulations"* (Mar. 14, 2016), available at https://www.sebi.gov.in/reports/reports/mar-2016/discussion-paper-on-brightline-tests-for-acquisition-of-control-under-sebi-takeover-regulations_31883.html [hereinafter "SEBI Discussion Paper, 2016"].
[22] *In re Kamat Hotels (India) Ltd.*, SEBI WTM Order No. WTM/GM/EFD/DRAIII/20/MAR/2017 (Mar. 31, 2017), available at https://www.sebi.gov.in/enforcement/orders/mar-2017/order-in-the-matter-of-kamat-hotels-ltd-_34538.html
[23] *Jet Airways and Etihad*, *supra* note 8, at paras. 13–20.
[24] Competition Act, 2002, *supra* note 5, ss. 5–6.

rights across all four laws and the regulatory purpose would shift behind each one.[25] This is where the shareholders' agreements become relevant. The shareholders' agreements show what rights the investors hold. The definitions show how these rights can actually be interpreted.

4.Consequences of the Gap

Shadow control exercised by investors despite being minority shareholders has far reaching consequences. Founders negotiate and enter into agreements for funding only to give up operational sovereignty. Decisions like the hiring of key managerial personnel, annual business plan, annual budget, making changes to the ESOP scheme, and so on would require the affirmative vote of the investor nominee director. Suddenly, decisions that decide the long-term growth and future of the company like entering into a new line of business, acquisition of another company or entering into a joint venture, would depend on the approval of the PE/VC investors.

This poses a concern because of the very nature of PE/VC funds which have a finite-horizon exit orientation. This can be through regulation as provided in Regulation 13 of SEBI (Alternative Investment Funds) Regulations, 2012 which specifies this structure or through contract between the funds and their Limited Partners.[26] In either scenario, this means that the fund has a fiduciary duty that requires an exit within a defined window. This directly clashes with the founders, common shareholders and creditors who do not have a comparable exit incentive. This can be observed through IPO covenants, which were present in all of the 10 SHAs analysed. Two of the SHAs even provided for an 'Investor Mandated IPO' according to which, after a fixed period of time, the investor had the right to cause the company to undertake an IPO by issuing a written notice to the promoters and the company. On the receipt of such notice the IPO must be completed within a period of 6 months. Interestingly, when the Promoters have a right to mandate an IPO, the same is subject to the consent of the investors but not the other way around.

Other factors affecting the company's direction are Management Incentive Plans tied to IPO

[25] SAST Regulations, 2011, *supra* note 4, reg. 2(1)(e); Companies Act, 2013, *supra* note 3, s. 2(27); FEMA NDI Rules, 2019, *supra* note 6, r. 2(da); Competition Act, 2002, *supra* note 5, Explanation (a) to s. 5.
[26] SEBI (Alternative Investment Funds) Regulations, 2012, reg. 13, Gazette of India, pt. III sec. 4 (May 21, 2012), available at https://www.sebi.gov.in/legal/regulations/may-2012/sebi-alternative-investment-funds-regulations-2012.

milestones or IPO readiness metrics. Such equity incentive plans which take the form of Phantom Stocks, ESOPs or exit-linked cash bonuses are used by PE/VC investors to align the company's management with the investor's performance and exit goals. These can in certain situations lead to the company's management prioritising short-term exit valuations over the company's long-term profitability which may go against the interests of the founders, public shareholders and the creditors. The consequences of this misalignment of interests become critical at times of corporate distress where the very reserved matters vetoes that give PE/VC investors operational control over the company provide the ability to freeze corporate actions on which restructuring depends such as additional financing under Section 179(3)(d),[27] disposal of assets under Section 180(1)(a),[28] further issue of capital or debt to equity conversion under Section 62(3).[29] Thus, a debtor company cannot execute restructuring whether through a bilateral workout with lenders or through a compromise or arrangement with creditors under Section 230 of the Companies Act without the consent of the PE/VC investor.[30] This consent is guided by the same fixed-horizon orientation rather than the company's long-term interests. When the company is in distress the PE/VC funds would prefer a sale that recovers their liquidation preference over a rescue financing round that would dilute their position and delay their exit. The nominee director, using their veto under the SHA's reserved matters clause can thus block the very financing that may save the company, in addition to causing creditors to bear the consequences of the resulting freeze.

The same divergence of interests was observed in US law by the Delaware Court of Chancery's decision in *In re Trados Inc. Shareholder Litigation, 73 A.3d 17 (Del. Ch. 2013)*.[31] In this case, the company despite increasing revenue year-over-year failed to meet the VC backers' expectations and thus the VC directors pushed for an exit via sale, and incentives were provided for management contingent on facilitating a sale even if it yielded nothing for the common stock.[32] This resulted in a sale which provided the preferred stockholders that is the VC investors $52.2 million and the common stockholders nothing, further losing the ability to gain any future value from their ownership of the company stock. The Court noted that by the very nature of the cash flow rights of the VC stock, their economic incentive diverges from that of

[27] Companies Act, 2013, *supra* note 3, s. 179(3)(d).
[28] *Id.* s. 180(1)(a).
[29] *Id.* s. 62(3).
[30] *Id.* s. 230.
[31] *In re Trados Inc. Shareholder Litig.*, 73 A.3d 17 (Del. Ch. 2013), available at https://courts.delaware.gov/opinions/download.aspx?ID=193520.
[32] *Id.* at 17–18.

the common stockholders and that the VC nominated directors had a clear conflict of interest.[33]

The conflict of interest of the VC nominee directors was explicitly acknowledged due to the fact that the beneficiaries of their dual fiduciary duties had diverging interests, which is a settled legal principle in Delaware law. Indian law addresses this but resolves it less firmly. According to Section 166(2) of the Companies Act, 2013, a director must "act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for protection of environment."[34] This in addition to Section 166(4) which provides that a director shall not act in conflict with the company's interest[35] casts a wide net when it comes to providing for what comes under a director's duties and although to whom the directors owe fiduciary duties between shareholders and the company is not explicitly stated, it is a general common law principle that the company takes precedence.

However, the application of this principle has not been as strict, as was observed in *Tata Consultancy Services Ltd v. Cyrus Investments Pvt Ltd, (2021) 9 SCC 449*[36] where the Supreme Court held that the nominee directors owe fiduciary duties to both the company and the shareholder who nominated them. The court in holding that the affirmative voting rights did not affect the director's duties placed reliance on the nature of the director nominators as public charitable trusts, which adds a layer of uncertainty as to whether the nature of the nominating shareholder affects whether nominee directors take their fiduciary duties towards their nominators into consideration or not. The Supreme Court in its judgement questioned the existence of independent directors if all directors are required under Section 166(3) to exercise independent judgement.[37]

Thus, on account of the above it can be surmised that the shadow control exercised by investors produces identifiable operational consequences (exit-timing distortion, management-alignment through MIPs, restructuring paralysis) and that these consequences are a result of the structural divergence between fund and stakeholder interests.

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[33] *Id.* at 51–53.
[34] Companies Act, 2013, *supra* note 3, s. 166(2).
[35] *Id.* s. 166(4).
[36] *Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd.*, (2021) 9 SCC 449, available at https://api.sci.gov.in/supremecourt/2020/212/212_2020_31_1503_27229_Judgement_26-Mar-2021.pdf
[37] *Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd.*, (2021) 9 SCC 449, paras. 19.12–19.30; Companies Act, 2013, *supra* note 3, s. 166(3).

5.The Deadlock Problem

Deadlock is not a flaw in the SHA governance framework but an expected feature. If any one shareholder (or group of shareholders) holds 20% equity and has affirmative voting rights over 25 or more areas of decision making then deadlock will always occur if there is a major disagreement between the minority and majority shareholders. Disagreement in the case of equal shareholders would get resolved by a majority vote. However, the shadow control via SHA reserved matters exercised by minority shareholders with just 15-20 percent of equity turns them into a blocking party for decisions that would be decided simply by a majority vote. This can be observed in the 10 SHAs analysed, wherein the reserved matters lists range from 11 to 25 items.

The Companies Act, 2013 already provides under Section 114(2) for minority shareholders to have the right to block special resolutions as they require a 75 percent majority to pass, which means a shareholder with above 25 percent equity can block any special resolution item they want without the need for any specific SHA veto rights.[38] The issue that the SHA framework causes is expanding this veto right from being about special resolution items to everyday operational decisions, relocating the veto from a shareholder meeting to the board level through the affirmative vote of the investor's nominee director. Thereby significantly decreasing the shareholding threshold required to block decisions provided in Section 114(2).

There are four main areas where this SHA structure results in deadlock. Firstly, annual budget and business plan, which are present in reserved matters in all the SHAs analysed and almost universally present in Indian PE/VC SHAs. The investor may focus on the top line of the company to meet exit criteria whereas the founder may focus more on cash flow to ensure long term sustainability. This can cause deadlock in the company. Secondly, recruiting and appointing Key Managerial Personnel, another reserved standard matter, can cause conflict causing deadlock in the company when they need strong leadership. Thirdly, further issue of capital, also a reserved matter in all SHAs analysed. Deadlock in this category can lead to the restructuring paralysis analysed in Part IV, leading to a potential block to financing that can save the company at a time of distress. Lastly, exit deadlock which manifests when the founders and investors disagree on the terms of a third party sale or IPO. As even though in many instances investors have unilateral initiation rights, they still require the founders cooperation

[38] Companies Act, 2013, *supra* note 3, s. 114(2).

for execution.

The resolution mechanisms provided in the SHAs themselves are not very fruitful for resolving a deadlock. Meetings between the elected representatives of parties essentially bring different people that have the same interests and institutional incentives to the negotiations. Arbitration, the main method of resolution relied on in SHA disputes, is for adjudicating legal rights; it cannot enforce a specific corporate decision that has been allocated to the veto holder by the SHA. When a reserved matters veto is exercised by the veto holder, there is no legal question for the arbitrator to settle. The remedies provided in the Companies Act, 2013 are not specially ideal either. Oppression relief under Sections 241 and 242 is an ex-post remedy.[39] Therefore the Tribunal can act only when oppression has been established and cannot act to prevent it from occurring. Just and equitable winding up under Section 271(e) is a remedy that destroys the very entity the parties are fighting over and thus used sparingly by courts and also is an ex-post remedy.[40]

Given these facts, there is no practical solution to a serious deadlock other than exit. Because when internal mechanisms have failed and statutory remedies act only after harm has occurred, the only way to break an operational paralysis is through one party's exit from the governance structure. Exit mechanisms provided in SHAs such as shotgun clauses, put-options, drag-along, forced buy-back are largely enforceable under the current jurisprudence with courts adopting a pro-exit approach in *Cruz City 1 Mauritius Holdings v. Unitech Ltd, (2017) 239 DLT 649*,[41] and *Vijay Karia v. Prysmian Cavi E Sistemi Srl, 2020 SCC OnLine SC 177*.[42] But the remedy provided in leading cases is damages. Which although compensates the party that was denied their exit, but it does not transfer shares, shift control or dismiss the operational vetoes that produced the issue of deadlock in the first place. The reserved matter vetoes that constitute shadow control function less like protective covenants for a minority investor and more like leverage over the timing and the terms of exit. The recommendations below propose reforms to address the issues caused by shadow control architecture.

[39] *Id.* ss. 241–242.
[40] *Id.* s. 271(e).
[41] *Cruz City 1 Mauritius Holdings v. Unitech Ltd.*, (2017) 239 DLT 649 (Del. HC) available at https://delhihighcourt.nic.in/app/case_number_pdf/2017:DHC:1911/VIB11042017EX1322014.pdf
[42] *Vijay Karia v. Prysmian Cavi E Sistemi Srl*, (2020) 11 SCC 1 : 2020 SCC OnLine SC 177, available at https://api.sci.gov.in/supremecourt/2019/11180/11180_2019_4_1502_20493_Judgement_13-Feb-2020.pdf

6.Recommendations

This paper has identified shadow control as a problem operating across both the regulatory and the contractual dimensions of Indian PE/VC investment, which harms the existing framework and neither prevents nor remedies in real time. This Part proposes targeted reforms addressing both dimensions.

6.1.Reasoned vetoes with defined fallbacks

A veto right protects the investor's economic interests. But an unrestricted or unlimited veto allows the same investors to interfere in the decisions of the investee company that are important for the functioning of the company. An unrestricted veto will give the arbitrator no legal question to resolve, and the legal remedies will be available only if there is actual damage.

Each of the reserved matters should identify economic rights that are protected by the veto/affirmative voting rights. An investor refusing the approval must give a written statement as to why the approval is not being granted, specifying what prejudice will be caused. Failure to respond should mean the consent has been provided.

In cases of disputes about the justification/approval, an independent arbitrator appointed in the beginning should determine only whether the reason lies within the economic interest mentioned in the contract. If it is not so, consent should be granted. All ten SHAs reviewed contain reserved matters to refuse approval of budgets and capital calls; nine contracts also have such reserved matters regarding the selection of managers. These decisions require clearly-defined fallback clauses. In case of a budget dispute, last year's budget should automatically continue with the previously agreed increment in the budget. In case of a dispute over agreeing to appoint a key managerial person, an interim manager could be appointed to fill the vacant position. Until completion of exit procedures, starting from service of an exit notice, veto power over budgets and selection of managers should yield to the ordinary-course covenants that are customary for acquirers before signing and closing of acquisition.

Different provisions will be necessary in case of financial distress. Financial distress will be defined objectively by one of the following tests: continuation of non-payment to a financial creditor beyond a certain number of days or a going-concern opinion in the auditor's report. While any of the conditions continue, the investor's consent should not be needed for financing,

issuing new securities, exchange of debt into equity, selling of the relevant assets for purposes of restructuring, as well as compromise with creditors. The board of Directors will continue making such decisions independently of the investor's consent. Nominee directors designated by the investor should not be allowed to refrain from voting because of statutory duties imposed on them. Investors will retain liquidation and pro rata rights of participation in such matters and would not retain the power to block it.

6.2.Governance schedules at signing

The contracts should carry aggregate governance schedules starting from the time of investment, containing every clause that can shape how the company can run. Reserved matters, Board Appointments, Information Rights, Quorum and exit mechanisms like Tag along/Drag along and put options. Against each of these rights, the recommended schedule should hold the shareholding and the time limit in which the negotiated rights fall away or are changed.

The schedule's function is to provide evidence and not to determine whether the investor has acquired control under the Companies Act 2013, the Indian Contract Act, SAST or FEMA-NDI. The actual function is to tell what governance package the parties negotiated and agreed to, so the parties don't have to piece together the clauses that are scattered among different SHAs.

6.3.Codifying Protective Rights under the Takeover Regulations

Under Regulation 2(1)(e) of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, ‘control’ includes the right to appoint a majority of directors or to control the management or policy decisions, whether such control is exercised through the shareholding, management rights, shareholders’ agreements, voting agreements or otherwise. The definition is broad and inclusive. It does not specify the rights that individually or in combination, cross the threshold into control for the purpose of the open offer obligation. SEBI itself has recognised this resulting ambiguity in its 2016 Discussion Paper on “Brightline Tests for Acquisition of ‘Control’ under SEBI Takeover Regulations”.[43] The Discussion Paper acknowledged that assessing control on the basis of contractual rights becomes complex and requires consideration of the facts of each case and has led to litigation. It proposed two

[43] SEBI Discussion Paper, 2016, *supra* note 21, at paras. 7–8.

alternative approaches. Option 1, which was a framework for protective rights. It identified a list of rights that were protective in nature and would therefore not amount to 'control'. Option 2 proposed the adoption of a numerical threshold for identifying control, namely 25 percent of voting rights or the right to appoint a majority of non-independent directors. However, neither of the two options were adopted and the Takeover Regulations continue to operate on a case-by-case approach, which according to the Discussion Paper had produced litigation and market uncertainty.

Therefore, in order to reduce market uncertainty, an effective approach would be to incorporate Option 1 either as an addition to Regulation 2(1)(e) or as a Schedule to the regulations. The Protective Rights framework constituting Option 1 builds on the work of the Bhagwati Committee[44] and the Takeover Regulations Advisory Committee.[45] It provides a pragmatic list of rights that would not amount to control under Regulation 2(1)(e), but it has sat without binding effect for a decade. Incorporation of a schedule of protective rights would provide a binding regulatory text that market participants could confidently rely on to provide clarity regarding what does and does not constitute control. With an increase in inflow of investment over the past decade, such a bright-line certainty would be significantly beneficial to all stakeholders.

7.Conclusion

The contractual governance of Indian private equity and venture capital deals has outgrown the corporate governance provisions of Indian law. The SEBI SAST and the Companies Act, 2013, recognise that control may be transferred through SHAs, but neither provides the criteria for determining what happens when the total of the rights of the minority shareholders adds up to control.

The shadow control structure can be seen in all the SHAs analysed for this paper. The reserved matters schedule ranged from 11 to 25 matters, out of which 5 matters were present across all the agreements. Clearly, such reserved matters take control much further than the limited scope of actions allowed that require shareholders' approvals as per the Companies Act, 2013.

[44] Report of the Justice P. N. Bhagwati Committee on Takeovers (Jan. 18, 1997), available at https://www.sebi.gov.in/takeover/takeoverreport.pdf

[45] Report of the Takeover Regulations Advisory Committee (July 19, 2010), available at https://www.sebi.gov.in/reports/reports/jul-2010/report-of-the-takeover-regulations-advisory-committee_717.html

Besides, all the SHAs provide quorum and board representation for the investors, so they are represented regularly in the board meeting of the company and have regular information that may not be present with other minority investors. Liquidation preferences exist at the time of exit. The board and the promoters continue to run the affairs of the companies.

The four definitions of control relevant for the paper only have slight phrasing differences: Section 2(27) of the Companies Act, 2013, and 2(1)(e) of SEBI SAST regulations have almost identical language, and FEMA (NDI) Rules after 2024 use the same language as the Companies Act for the definition of control. The threshold for material influence is set by the Competition (Amendment) Act 2023. The SAST regulations are on the stricter side, as any acquisition of control triggers the open offer under Regulation 4 irrespective of the shareholding percentage, but the answer remains open.

A private equity/venture capital fund has a limited life and has to exit within a specific period of time. Whereas the creditors and the shareholders will stay forever. In a situation of financial distress, the veto rights may prevent the steps that are necessary for restructuring, rescue finance, asset sale, debt-to-equity exchange or compromise with the creditors. Deadlock is a result of fundamental disagreement between both sides. There is nothing left for arbitration to decide once a veto is used, and remedies for oppression and winding up are available under the Companies Act, but they come too late. While denial of an exit path results in the awarding of damages, which transfers no shares and leaves the vetoes intact. The vetoes give the investor the ability to control the timing and conditions of exit. Reforms would remedy this problem at both contractual and regulatory levels. Reasoned vetoes and established fallbacks would prevent obstructive behaviour. Establishing criteria regarding protective rights in SAST regulations would add predictability, while still leaving room for scrutinising transactions that entail the conferral of material decision-making power. Control, the argument goes, must be determined through an examination of the functioning of governance rights cumulatively and not percentages or individual transactions. The assessment must also take into consideration the specific statutory objective for which it is made, as merely material influence can amount to control. Overcoming the problem posed by shadow control would require elimination of the cumulative impact on governance that prevents the company from governing itself and requires establishing a framework that would protect the minority investor's rights.