EXIT RIGHTS

-Share Subscription and Shareholders Agreement-

Supplemental to our previous writing on **'Investor Protection Rights - Share Subscription and Shareholders Agreement'[1],** this article focusses on various 'Exit Rights' sought and negotiated by the Investors while making investments, where such Exit Rights are aimed towards providing an exit opportunity to such an Investor in either of the following manners:

a. by the sale of shares held by such an Investor on predetermined terms; or
b. through facilitation of the sale of such shares by the Company or Founders on predetermined terms.

Under certain conditions, the Exit Rights may also, in some cases, be triggered upon sale of shareholding by the Founder or other Investors.

This article is intended towards enabling the Founders and Investor alike to comprehend the nuances involved in negotiating the terms concerning Exit Rights, and to safeguard their respective interests vis-à-vis the underlying object of the proposed transaction. The agreed terms as a result thereof form part of the Investment Agreement (Share Subscription and Shareholders Agreement).

IMPORTANT CLAUSES

1. Tag-Along Right

The Tag-Along Right ("TAR") is a co-sale right that provides certain shareholders of a Company a right to participate in the sale of shares of the company by other shareholders to any third party on the same terms and conditions. In practical parlance, an investment in a start-up is generally made by an Investor based on the trust and reliance over the skill, background, and ideas of the Founder(s), and therefore, such an Investor would desire that the Founders continue with the company towards the common goal after an investment is made by such an Investor.

TAR, as an exit mechanism, is intended to protect the interest of an Investor in the event any of the Founders (that is, Selling Founder) intends to transfer his shareholding to any third-party, whereby in such an event, the Investor shall also have the right, which the selling founder shall ensure, to transfer the shares held by such an Investor as well to such third-party fully or on a proportionate basis in the manner as agreed in the Investment Agreement. Any sale to a third party by the Investor shall be on the same terms at which such third party acquires shares from the Founder(s).

TAR is a right available with an Investor which such Investor may or may not exercise. TAR is closely associated with the 'Right of First Refusal' (investor protection right) available with an Investor. TAR is generally exercised by an Investor when, upon proposed partial or full exit by any of the Founders by the sale of shares to any third-party, the Investor deems it appropriate to take

[1] Investor Protection Rights vis-à-vis Founders' Rights
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an exit by follow-up sale of its shareholding to such third-party, and also, therefore, does not exercise its Right of First Refusal. Alternatively, the Investor may not exercise TAR and continue with his shareholding in the company even after the exit of any of the Founders, while also exercising or waiving its Right of First Refusal.

The following essential aspects may be considered by the parties to an Investment Agreement while negotiating on the TAR provisions:

i. TAR shall only be triggered with respect to proposed sale by Founders, or other specified class of shareholders, to any third party.
ii. TAR is a right available with an Investor where the Investor may exercise such a right at its discretion. However, once the same is exercised, it becomes obligatory upon the Founders (or any other specified class of shareholder, as the case may be) to fulfill its obligations towards TAR.
iii. TAR may sometimes be sought by the Seed or Angel Investors (minority shareholders) on the sale of shares by any future lead Investor(s).
iv. Founder's (or of any other specified class of shareholder, as the case may be) obligation to facilitate the sale of shares held by Investor exercising TAR to any third-party may be restricted to a proportionate shareholding of the Investors. However, in case of sale of the major chunk of shares (as may be quantified and specified in the Investment Agreement), the TAR may be provided or sought with respect to the sale of all the shares (as opposed to proportionate shareholding) held by the Investor.
v. The Investor must be allowed a specific time-frame under the Investment Agreement in which such an Investor may offer its shareholding for sale under TAR.
vi. The terms of sale of the Investor's shares under TAR shall be the same or more advantageous than that of the Founders.

2. Drag Along Rights

The Drag Along Rights ("DAR") entitles an Investor proposing to sell his shareholding in the company to any third party to necessitate the Founders to also sell shareholding held by them. Generally, DAR is vested with the Investor only after a certain mutually agreed period has passed since the investment made by such Investor in the company, that is to say, the Investor has not been provided an exit (through other exit mechanisms set forth in the Investment Agreement) from the company during such mutually agreed period. DAR is normally associated with other exit mechanisms of the Investor envisaged in the Investment Agreement, such as Initial Public Offering (IPO), third party sale, and others. In the event where an exit is not effectuated within a specified period, the Investor may invoke his Drag Along Right.

The parties to an Investment Agreement must be extremely careful in incorporating DAR provisions in the Agreement. The invocation of DAR by an Investor shall result in Founders compulsorily selling their shareholding in the company, thereby, resulting in the forced exit of Founders from the company irrespective of their roles in the company or prejudicial impact on the business operations of the company. Further, any invocation of DAR may not be in the interest of Investors (other than the ones exercising DAR) as such Investors might also have invested in reliance upon the skill and conduct of the Founders, and therefore, upon forced exit of the Founders, they may be rendered helpless.

Consequently, upon the departure of Founders by virtue of the exercise of DAR by an investor, other Investors may also rush to sell their shareholding in the company. Ultimately, the exodus of Investors may inordinately lead to the ownership of the company with third parties while bringing the business operations to a standstill. Therefore, it is highly important that DAR to any Investor or group of Investors may be provided after due deliberations.

3. **IPO.** The Investors look for the terms providing for the Company to come up with the IPO within 4 to 5 years from the time of investment being made in it, failing which the Company or the Founders to either facilitate any third party exit to the Investor or to provide the exit by the Founders, at the value not less than the investment value plus interest or the fair value, whichever is higher. This needs to be carefully assessed considering the business plans, and projected statements of the Company.

   The provisions are triggered at the time the company proceeds for an Initial Public Offering (IPO), whereby an Investor reserves the right to offer the shares held by it for sale in the said IPO. Such a right is exercisable by the Investor at its sole discretion, and any sale of shares held by it shall be permitted for sale subject to and in accordance with the maximum extent permissible under the applicable laws. The Founders and the company are required to undertake and do all the acts and deeds necessary to give effect to such a right with the Investor, that is to say, the Founders and the company shall ensure the sale of shares held by the Investor in the IPO in accordance with applicable laws. The parties to an Investment Agreement may negotiate upon limitation towards Investor's participation in the IPO, such that more funds may be raised through primary issuance under IPO.

4. **Liquidation Preference.** Upon happening of any liquidation event, that is predefined and agreed upon by the parties in an Investment Agreement, resulting in the company advancing into liquidation, the Investor (all or any) shall have preference over all other shareholders (may or may not include other Investors, and but including Founders) of the company with respect to the participation in liquidation proceeds. Such liquidation preference and resulting participation in liquidation proceeds shall be on the terms as may be agreed upon by the parties in the Investment Agreement. The participation in the liquidation proceeds corresponds to the investment made by the Investor in the company, and therefore, the parties to an Investment Agreement may deliberate upon the payment of any premium to the Investor out the liquidation proceeds and incorporate the requisite provisions accordingly. Anything remaining after paying off the Investors in preference to the rights they have in liquidation preference shall be distributed among other shareholders.

   Some of the general liquidation events include any liquidation, dissolution, asset sale, restructurings/re-organisations, merger, acquisition and/or change of control or winding up of the company, or other transaction or series of transactions in which the company's shareholders prior to such transaction or transactions will not retain a majority of the voting power of the surviving entity, and others.

5. **Sale to third party.** The provisions put an obligation upon the Founders to facilitate the exit of the Investor within a predefined period. The Founders is obligated to facilitate the sale of shares held by the Investor to any third-party at a predetermined price (such as fair value), thereby, resulting in the exit of the Investor from the company. In the event the Founders fails to facilitate such sale to any third-party, the Founders shall personally be obligated to acquire the Investor's shares at the predetermined price (such as fair value). Such a provision must carefully be incorporated in an Investment Agreement as the provision puts a personal onus on the Founders to acquire shares of the Investor. Having said that, and without prejudice to the requirement to facilitate a sale to third-party, the parties may incorporate acquisition by the Founders as a non-mandatory provision.

6. **Transfer to Competitors**. The provision forbids any party to an Investment Agreement (including Investor) to sell the shares held by such party to competitors of the company, notwithstanding the fact that the proposed sale is in pursuance of any right envisaged in the Investment Agreement. Such a provision ensures that the control of the company is not held by any competitor at any time.

7. **Other Exit Rights**

   7.1. **Call Option:** Call Option provides certain rights to an Investor, whereby the Investor shall have the option (and not the obligation) to call upon other shareholders (including Founders) to compulsorily sell the shares held by such shareholders to the Investor invoking call option. Such compulsory sale is made at a predetermined price, which may include a sale at fair valuation or at a specified internal rate of return (IRR) or at price calculated through any other agreed mechanism. The Investor, by invoking the Call Option, essentially makes compulsory exit of other shareholders (s) while increasing his stake in the company. Such a provision may bring forced exit of the Founders from the company, and therefore, shall be incorporated cautiously in the Investment Agreement. Consequent to the exit of Founders as a result of Call Option, other Investors (not being party to this option) may also view to take an exit from the company. Thus, the company, founded by the founders, could ultimately be under the ownership and management of such investor shareholders.

   The Investors look for these rights in the event of the Material Default or Material Breach by the Founders. Thus, how these Material Default or Material Breach are defined are also needs to be reviewed carefully.

   7.2. **Put Option:** Put Option grants an option (and not the obligation) with an Investor to compulsorily require the Founders to purchase the shares held by such Investor upon happening of any specified event at a predetermined price. The provision, thus, provides an exit route to an Investor who intends to take an exit from the company, though it shall be a discretionary option with the Investor whether to exercise such right or not. The provision shall extensively be deliberated upon as it leads to compulsory sale by the Investor, and other Founders may not be in a position to honor their obligation by purchasing the shares held by the Investor. Granting any such right shall require approval of other Investors as well, which in turn may be time-consuming with no effective end result.

The Investors look for these Call Option and Put Options rights in the event of failing IPO or the Material Default or Material Breach by the Founders. Thus, how these Material Default or Material Breach are defined are also needs to be reviewed carefully. Also, such rights may pave way for the opportunistic purchase or sale of shares by Investors viewing the valuation of shares/convertible securities at a given point in time.

Every business operates with money invested into it, and by investing into the Company, every Investor looks for not only protecting such investment but also for its exit rights and making profits. Similarly, every business runs on an innovative idea and the effective implementation of such idea by the Founders of such a business but such innovative ideas may fail due to different internal and external factors. Thus, it is both the Founders and the Investors that play important roles in the development of the business through their respective means with a view to earn profits, so while providing such exit rights, it is important to frame a balance of both the Investors and the Founders while executing Investment Agreements.

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