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LEGAL ASPECTS OF VENTURE CAPITAL AND PRIVATE EQUITY IN INDIA

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INTRODUCTION

Venture capital (VC) and private equity (PE) have become important sources of finance for Indian businesses. Start-ups in areas such as fintech, healthcare and e-commerce, as well as established companies, increasingly depend on institutional investors for capital and strategic support. Such investments are not only financial transactions; they are also governed by securities law, foreign exchange rules, company law and negotiated contracts.² The Indian framework has developed through several statutes and regulations, but questions about the protection and enforcement of investor rights remain important.

REGULATORY FRAMEWORK

India does not regulate VC and PE under a single comprehensive statute. Domestic funds are primarily governed by the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012. These regulations classify alternative investment funds into three categories. Category I includes venture capital and certain start-up funds; Category II includes private equity and other funds that do not engage in the activities of Category I or III; and Category III covers funds that use complex trading strategies and leverage.³ The regulations also prescribe requirements relating to corpus and minimum investment.⁴

Foreign investment adds another layer of regulation. The Foreign Exchange Management Act, 1999 (FEMA), together with the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, governs many inbound equity investments and sets out applicable pricing, sectoral

restrictions, and approval requirements.⁵ Press Note 3 (2020) introduced prior government approval for investments involving beneficial ownership from countries sharing a land border with India.⁶ The investee company must also comply with the Companies Act, 2013, particularly rules concerning private placement and preferential allotment.⁷

DEAL STRUCTURING AND INVESTMENT INSTRUMENTS

A VC or PE transaction normally begins with a term sheet setting out the principal commercial terms. Although many provisions are intended to be non-binding, clauses dealing with confidentiality, exclusivity and costs may be binding.

For foreign investors, the choice of instrument is closely connected with FEMA. Equity shares and specified compulsorily convertible instruments are generally treated as equity under the Non-Debt Instruments Rules, while debt instruments fall under the separate foreign borrowing framework.⁸ Shareholders' agreements contain negotiated protections, but important provisions should also be reflected in the company's Articles of Association, where corporate enforceability is required.⁹

INVESTOR RIGHTS AND ENFORCEABILITY

Investors commonly negotiate liquidation preference, anti-dilution protection, reserved matters, board representation and information rights. These provisions can provide investors with significant contractual protection even when their percentage shareholding is limited. However, contractual rights must operate within statutory restrictions, particularly those governing foreign exchange and securities.¹⁰

Enforceability has historically been a major concern. In *V.B. Rangaraj v. V.B. Gopalakrishnan*, the Supreme Court held that a restriction on share transfers not contained in the Articles could not bind the company.¹¹ The decision encouraged parties to incorporate important shareholder-agreement rights into the Articles. In *World Phone India Pvt. Ltd. v. WPI Group Inc.*, the Delhi High Court similarly considered the effect of an affirmative-vote provision that had not been incorporated into the Articles.¹² At the same time, the Companies Act, 2013, now expressly provides that a contract or arrangement between persons concerning the transfer of securities is enforceable as a contract.¹³

EXIT MECHANISMS AND LEGAL HURDLES

Exit is a central concern in VC and PE transactions. Common routes include an initial public offering, a strategic sale, a secondary sale and a company buyback. Each route is subject to different legal requirements. For example, public-market exits may involve lock-in requirements under the SEBI Issue of Capital and Disclosure Requirements Regulations, while buybacks are regulated by the Companies Act.¹⁴

Investors may also negotiate drag-along, tag-along, put and call rights. These provisions must be drafted carefully because a fixed or assured exit price may conflict with restrictions applicable to foreign investment. SEBI has permitted certain pre-emption and option arrangements subject to conditions relating to holding periods, lawful pricing and actual delivery of securities.¹⁵

COMPETITION AND TAX CONSIDERATIONS

Competition law can affect large investments. A transaction may qualify as a combination under the Competition Act, 2002, requiring examination of the applicable asset, turnover or deal-value thresholds and, where applicable, prior approval from the Competition Commission of India.¹⁶

Tax rules also influence investment structures. The tax on certain share premiums received by unlisted companies, commonly referred to as angel tax, was removed through the Finance (No. 2) Act, 2024.¹⁷ Category I and Category II alternative investment funds also receive pass-through treatment for specified income, subject to the Income-tax Act.¹⁸

CONCLUSION

India has developed a detailed legal framework for VC and PE investment through SEBI regulations, FEMA, company law, competition law and tax legislation. The framework provides mechanisms for investment, governance and exit, but the practical value of these rights depends on careful drafting and enforceability. The development from V.B. Rangaraj to the statutory recognition of transfer contracts under section 58(2) shows that the law continues to respond to commercial needs.¹⁹ Clearer coordination among regulators, careful alignment between shareholders' agreements and Articles of Association, and efficient dispute resolution can provide greater certainty to both investors and companies.

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² Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012; Foreign Exchange Management Act, 1999, No. 42 of 1999 (India); The Companies Act, 2013, No. 18 of 2013 (India).

³ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, reg. 3(4) (India).

⁴ Id. reg. 10.

⁵ Foreign Exchange Management Act, 1999, No. 42 of 1999 (India); Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, G.S.R. 707(E) (Oct. 17, 2019) (India).

⁶ Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Press Note No. 3 (2020 Series) (Apr. 17, 2020) (India).

⁷ The Companies Act, 2013, No. 18 of 2013, §§ 42, 62(1)(c) (India).

⁸ Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, G.S.R. 707(E) (Oct. 17, 2019) (India); Foreign Exchange Management (Borrowing and Lending) Regulations, 2018, G.S.R. 121(E) (Mar. 26, 2018) (India).

⁹ The Companies Act, 2013, No. 18 of 2013, §§ 5, 10, 58(2) (India).

¹⁰ The Companies Act, 2013, No. 18 of 2013, §§ 5, 10, 58(2) (India); Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 (India).

¹¹ V.B. Rangaraj v. V.B. Gopalakrishnan, (1992) 1 SCC 160 (India).

¹² World Phone India Pvt. Ltd. v. WPI Group Inc., USA, 2013 SCC OnLine Del 1098 (India).

¹³ The Companies Act, 2013, No. 18 of 2013, § 58(2) proviso (India).

¹⁴ Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, regs. 17–18 (India); The Companies Act, 2013, No. 18 of 2013, § 68 (India).

¹⁵ Securities and Exchange Board of India, Press Release No. 98/2013, “SEBI Permits Contracts for Pre-emption and Options in Shareholders Agreements” (Oct. 3, 2013).

¹⁶ The Competition Act, 2002, No. 12 of 2003, §§ 5–6 (India), as amended by the Competition (Amendment) Act, 2023, No. 9 of 2023 (India); Competition Commission of India (Combinations) Regulations, 2024 (India).

¹⁷ The Finance (No. 2) Act, 2024, No. 15 of 2024 (India) (omitting Income-tax Act, 1961, § 56(2) (viib)).

¹⁸ Income-tax Act, 1961, No. 43 of 1961, §§ 115UB, 10(23FBA) (India).

¹⁹ The Companies Act, 2013, No. 18 of 2013, § 58(2) proviso (India); V.B. Rangaraj v. V.B. Gopalakrishnan, (1992) 1 SCC 160 (India).