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ANALYSIS

# Private Equity | Stress-Testing the Deal: Key Investor Protections in Downside Scenarios




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## Key Takeaways

- Despite liability shields, nominee directors can still face harsh and long regulatory scrutiny – observer right provides a safe vantage point for investor, along with the standard directorship right
- Chairperson appointment is often overlooked – but chairpersons have discretion over the minutes, which is the primary source of evidence of board proceedings in dispute scenarios
- The exit right is the most important for investors – don't freeze them - if market conditions are sub-optimal, investors should have the ability to delay exit timings
- Investors and companies should be careful with how their exit waterfalls are worded – these are closely examined in dispute scenarios
- How can investors fairly distinguish between different EODs and their consequences?
- Assignment rights – investors should ensure that their personal obligations (especially towards business) continue irrespective of the transfers

You fund the company, you negotiate a robust SHA, yet you remain exposed when things go south.

Not all downside scenarios are considered when making an investment in ordinary course. Understandably so. When things are going well, downside mitigants could appear as procedural thorns. But ignoring them altogether could also end up being a costly affair.

SHAs include a litany of rights. This article highlights a few considerations which are often overlooked by investors when negotiating the key investment protection – the shareholders' agreement, and which can become relevant when things go south.

## 1. Is an observer right necessary if investors have the right to nominate a director?

First, why have the right to nominate a director? Of course, directorship right provides investors oversight over board documents (notices, matters, minutes, documents and the like), and more importantly it provides the opportunity to participate in decision-making. But what about liabilities – is there really a safe harbour?

To be very clear, executive management/ directors and non-executive directors (which nominee directors usually are) are treated differently under law. Specifically, under s. 149(12) of the Companies Act[1], an investor's nominee director is only liable for a Company's actions (or lack thereof) if they have knowledge of an action/ omission through a 'board process' and if they 'consented or 'connived' to a decision or failed to act 'diligently'.[2]

So, a stranger calling a nominee director to tip-off a fraud should not automatically mean that the nominee had 'knowledge' about the fraud – since this isn't strictly board process. Rather, 'board process' may be understood as formal processes involving directors in their capacity as board members (and not just any source of information). Regulators then have to also demonstrate that a director effectively allowed the decision to happen or did not act diligently.

But despite the safe harbour, in regulatory investigations and court proceedings, the process itself can often be the punishment. Take for example, the case of the non-executive directors involved in the Satyam fiasco (in 2009), where proceedings extended all the way till 2024, or when the SC restored proceedings against PNB's nominee in Bhushan Steel in 2025 after proceedings were dropped in 2020.

These trials can at times be long, drawn out and reputationally damaging for those involved. Nominees can try to resign instantly at the first sign of distress, but it's possible that they are still investigated for proceedings which occurred when they were part of the board[3].

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[1] "*(ii) a non-executive director not being promoter or key managerial personnel, shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently*".

[2] S.463 of the Companies Act also provides a safe harbour where a court believes a director "*is or may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused*".

That's where observers come in play. They have no stated role in the company's decision-making and do not have statutory recognition. They are shielded from director liabilities, but also get the right to attend board meetings. The more balanced approach therefore would be to obtain both rights in the SHA – retain the option to relegate to an observer position should things go sour.

## 2. Does chairperson appointment matter if they have no casting vote?

The role of a chairperson is often undermined in SHAs. Some even consider that the chairperson's only importance is whether they have a casting vote (i.e., a tiebreaker vote).

But that isn't entirely accurate. Under law,[4] the chairperson controls an important element, i.e., the minutes of the board of directors. Chairpersons can exercise discretion to decide what is included and excluded from minutes. This is critical in dispute scenarios since minutes form the primary basis of evidence of what was discussed in a board meeting and what was not.

Even if the law prescribes safeguards[5] and contractual requirements are incorporated (eg requiring that all minutes must first be approved by nominee directors), these are ultimately workarounds at best. In contentious scenarios, where uncooperative parties are involved, investors may be on the backfoot, having to continuously challenge the validity of the minutes or enforce their rights, which can be quite frustrating when time is of the essence. In the long run, an apparently procedural right can provide rather important protection in a dispute situation.

## 3. Are your exit rights well thought out?

The exit process is one of the important rights to closely examine in an SHA. For instance, the SHA may say: first attempt an IPO within a prescribed period. If that doesn't happen, run the first sale process. If that fails, then run a second sale process within another closely prescribed window. On paper, this looks thorough and protective.

But practically, if the first sale process does not attract serious buyers, what changes in the second process? The same asset, same market conditions, same financial profile – just another formal round. If the first attempt fails due to lack of appetite or weak valuation, a second "mandatory" process within a closely prescribed timeline may simply repeat the same outcome. In this scenario, the company ends up fulfilling procedural obligations without achieving liquidity for the investor.

That is where the investor's right to vary timelines become critical. Investors should try to negotiate the right to delay exit timelines where market conditions are not optimal. This is especially important in context of timing IPOs (the most lucrative route for investors). Of

[3] For completeness, it may be noted that the Ministry of Corporate Affairs has provided guidance (see: General Circular No.1/2020) to the regulator in India to only prosecute non-executive directors (in civil or criminal proceedings) if the above criteria can be established. That said, given the way different thresholds are applied in courts, it's difficult to say whether the circular provides any real, practical protection.
[4] Secretarial standard 1.
[5] The chairperson's discretion to exclude matter extends only to matters which are in their opinion or may be reasonably regarded to be irrelevant or immaterial to the proceeding, or detrimental to the interests of the Company or defamatory to any person. The director also has the right to provide comments on the minutes which are circulated to the directors, but again, the chairperson holds discretion to consider the comments or not. Similarly, if the chairperson is not present to consult with when calling a board meeting, the MD or another executive director can be consulted.

course, the question could be – why would the company / promoters want to IPO in a sub-par environment? The answer would lie in specifics of each situation – but better have it than not. IPO unleashes the highest value, so its efficacy must be carefully guarded.

Second, we speak for target companies and their promoters. They should carefully word exit waterfall provisions. In dispute settings, arbitrators typically focus only on the fine print of the contract (rather than any interpretive material outside the contract).

In one case[6] where the SHA prescribed a detailed exit waterfall for investors (IPO, secondary sale, buy-back, second IPO, strategic sale), it was held that the obligation to provide the secondary exit (if the IPO failed) was an "absolute obligation… to find a buyer for the shares". In other words, if the company could not find a buyer, it was required to provide the exit itself. The company couldn't rely on the remaining waterfall to argue the secondary sale obligation was only an obligation to attempt the sale. Had the SHA documented that the company was only obligated to 'facilitate efforts to find a buyer' (instead of a 'shall find a buyer'), it may have been able to rely on the remaining waterfall.

Merits aside, the decision provides insight into how closely exit provisions are examined in dispute scenarios, which can be decisive if investors ever find themselves stuck at the time of an exit.

## 4. Should investors insist that Founders give up their shares and resign for all EODs?

While indemnities are better suited in the SSA for past acts (where risk can be quantified and capped), the primary remedy for a breach of an SHA covenant is usually an Event of Default (EOD) remedy.

What is an appropriate remedy? Should the founder be removed from directorship/ employment, should the founder's shares be taken away (and at what valuation), should their transfer rights fall away? These are just some of the questions which investors may ask when examining an event of default framework in an SHA.

Some patterns are common. But there is no one-size-fits-all approach. One approach is to classify mechanisms based on whether the underlying events are actions which are within the founders' control and high-threshold, as opposed to events which may not necessarily be within their control or lower-threshold.

For example, fraud/ wilful misconduct/ gross negligence are actions, which are fairly difficult standards to establish (since they require a higher degree of intention to be proven),[7] could require the founders to give up their shares at minimal value.

Other examples of EODs which could be classified as high threshold and within a founder's control include breach of key protective provisions by the founder (non-compete/ non-solicit,

[6] Nagaraj Mylandla v PI Opportunities (Supreme Court, 2025).
[7] Wilful misconduct for example has been held to mean an intentional disregard of duty, intentional cause of loss to any person, an omission done to intentionally cause mischief/ loss to a person (Indian Airlines v. Kurian Abraham (Kerala HC); Roshan Umar Karim v. The Madras and Southern Mahratta Railway Co; Jamunadas v. E.I. Ry. Co (Patna HC)). Gross negligence has similarly been interpreted to mean a failure to exercise care which even a careless person would exercise, or a wilful, wanton or reckless misconduct (ICAI v. Mukesh Gang (AP HC, 2016).

key reserve matters, devotion to business, etc.). These are just a few examples. Ultimately, investors should ask this question for each EOD – is this really within a founder's control should ask this question for each EOD – is this really within a founder's control and if yes, is it important enough to warrant a strong disincentive? The remedy could be nuclear. Investors should also negotiate to ensure that they are able to initiate an audit at their discretion as a pre-emptive measure.

Lower threshold events could lead to a remedy that doesn't penalise the founders, but puts the investors in charge. For example, expanded veto rights, the ability to appoint a majority of the board, and the right to remove the founder from management if necessary. Founders may be allowed to keep their vested shares in these scenarios.

Finally, EOD triggers should make practical sense. For example, there is a significant practical difference between mandating that FIR is a trigger versus filing of a chargesheet. An FIR may be active for multiple months, even if no chargesheet is filed, by which time, there could have been significant loss to the company. Ultimately, an effective EOD framework allows investors to ensure they have proportionate remedies.

### 5. Should founders be permitted to freely sale their shares to relatives/ their own estate?

It's quite common to see founders negotiate a right to freely transfer their shareholding to their immediate relatives or estate. What's important here is to ensure that founders continue to remain liable for any personal obligations which they have (eg: devoting time to business) irrespective of how many shares they hold. Investors should ensure that these obligations are documented to be personal in nature and not just linked to the founder's shareholding. We should allay a situation where founders, basis transfer of their shares to relatives, argue that they are technically no longer personally liable for their obligations as CEO or driving the operations.

## Conclusion

These are just a few examples of considerations that may seem unimportant at the investment stage, but which can become important once situations become contentious. Investors and companies alike would do well to consider these matters in advance so that they do not later find themselves trapped in such situations.

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