THE COMPLICATED RELATIONSHIP BETWEEN FAMILY BUSINESS AND VENTURE CAPITAL FIRMS IN INDIA

By Madhav Gawri
From Vivekananda Institute of Professional Studies, I.P. University

Family values, practices, and beliefs are kept on the highest pedestal in India. These rituals and beliefs have also affected the business avenue of the family. The nomenclature in India has been, a doctor's kid will become a doctor, a teacher's kid has to opt for teaching as a profession, and a businessman's child will continue his family's privately owned business. This culture of children following their parents’ strides has continued till the 21st century and it will do so, many centuries to come in India. This practice has also led to the development of keeping one's family business very close. Family business as defined by oxford dictionary is 'a business that is owned or run by members of a single family.' In India, the same definition is upheld. Whether it is to fund a business or to expand or take managerial advice, almost every aspect of a business is overseen or supervised by a family member. This creates a closed group amongst the members of the business in India. The classification for Indian family businesses has turned out to be of a closed group, with no external interference, advice, and managerial or business counsel.

Whereas, a venture capitalist looks for businesses to nurture and grow them, then cash out on them for a substantial return on their investment. The nature of work of a venture capitalist is to work together and utilise the concept of synergies of resources to the business and assist them to grow and expand their magnitude of work. There is a misconception amongst the Indian family business culture that venture capitalists bloat the valuation of a business and liquidate their investment and leave the business at a compromising stage. However, the venture capitalist aims to exit their investment for a substantial consideration, though they do not leave a business in a compromising position. A venture capitalist helps a business to stand on its own. They nurture a potential business, make it self-sustaining, and organise the business in such a way that they don't have to rely on external help. It removes the element of dependence. Moreover, venture capitalist uses their vast knowledge and industry experience to help the management of the business to make the right decisions. The management of the business knows the business aspect which they are concerned about. They might not have the vast knowledge of the whole industry which they are part of, whereas a venture capitalist is involved in numerous businesses. They have industry knowledge and experience. With this, they can make correct decisions, and correct the decisions of others as well.

This paper aims to study and analyse the current issues and the rationale why the Indian Family Businesses do not welcome and inculcate the venture capital culture into their businesses. Further, this paper aims to provide viable and reasonable solutions to these issues.

1) Family Values against Profit Margins

The concept of family businesses is very prominent in Indian culture. The management of the said business is run on cultural, religious values, and beliefs of that particular family. For example, the management of the family business usually consists of male members, which is headed by eldest one. Moreover, the succession of the family business is not usually determined by the talent and zeal of that person, it is determined by the next male member and his family heritage.

Family values have found an important role while running a family business. For example, if a restaurant is run by a section of the 'Jain' community then, it most probably would not serve food with onion and garlic. Moreover, material decisions in a family business are taken only after a thorough discussion with every family business. Though the final say is of the male head of the family business.

It is due to the above-stated values that family businesses and as well as venture capitalists do not wish to collaborate on the business field together. A venture capitalist in India sets to acquire a minority shareholding along with an ability to influence material decisions of a business, whereas, a family business hardly relinquishes its power to an external influence. Moreover, Venture capitalists strive to inculcate every possibility of revenue in the business, regardless of values. If it is economically feasible and has the potential to generate revenue then it should be a part of the business.

2) Strong Minority Shareholding of Venture Capitalist

Management of the business has the knowledge and experience of that business they run, whereas a venture capitalist sees, watches and learns the tactics, methods, and mistakes other businesses make and better themselves on every investment and decision they make.

In India, venture capitalists and private equity firms cannot follow the traditional western model of leveraged buyouts (LBO) due to various regulations laws. The majority of venture capitalists in India undertake "growth" deals with a strong minority investment in public or private companies. With this minority shareholding, the investor possesses to control the material decision of the business. The share subscription/share purchase agreement allows the venture capitalist to govern their investment in the business.

On the other hand, a family business is always reluctant to relinquish any power or

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authority to an external party. Moreover, they might be willing to raise investment by selling a minority shareholding but they never relinquish authority or give voting rights to that minority shareholder.

Though an agreement can be drafted in such a way that it allows the venture capitalist to interfere on limited matters and further the extent of interference can be established then there be an agreement between the parties. The management of the family business should be willing enough to relinquish control to some extent which will allow the venture capitalist to fit in. The management should make sure that other shareholders of the business should not be able to interfere with the transfer of share by improper exercise of power. This allows the venture capitalists to invest in the business and utilise their knowledge for the benefit of the business. A relationship of trust and interdependence should be built which will allow a strong collaboration between the two.

3) Bank Loan versus Venture Capitalists Funding for Family Business

The nomenclature amongst the family businesses in India is to take small business loans from banks. This allows them the flexibility which no other funding instrument does. There is very little influence in spending the loan amount. Whereas, investors demand influence and authority in the company in which they are funding. They want a vote in material decisions. However, if the company goes belly up, then you have no liability to return the lost money. A business loan comes with set pre-existing terms and conditions including a recovery schedule. Though a loan does not require equity against it. Raising money from a bank loan, the formalities are completed in the span of two to six weeks. The funds are received early as compared to receiving funds from a venture capitalist. Closing a deal with a venture capitalist can sometimes prove to be a herculean task. The investors conduct thorough due diligence to check whether the company is in terms in every way. The investors will also reach out to people who are in the company's network as the party of their due diligence process.

If a contract is negotiated properly and with parties' consent a creative solution to this problem can be reached in form of is convertible instruments. Hybrid securities like convertible debt instruments can be used and a situation is devised in such a way where the family business can issue convertible debt instruments to the venture capitalist. This instrument subsequently is converted into equity in the family business, if both the management of the company and the investor are satisfied with each other's work and the relationship that they have built up during that period when the instrument was of debt in nature. This period can be considered as a probation period between the venture capitalist and the management of the family business. The relationship can be taken further or terminated after the end of this probation period as the parties seem fit. These hybrid instruments allow the family business and venture capitalist to build relations first then they can choose to commit their resources and efforts on basis of that relationship.

4) Lineage of Business

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A family business is built on values and cultural practices. Parents’ guide their children in such a way in India that they usually follow in the footsteps of their parents. An engineer's child will be guided to become an engineer, a doctor's child will be guided to become a doctor, and so forth. The basic principles, these businesses are built on are a strong basic foundation. They intend to build a business that will be managed and run by generations to come. They aspire to build a legacy that they can pass on to generations to come. This is the main reason that family businesses prefer bank loans over venture capitalists. For family businesses, it might affect the passing on of ownership from one generation to the next generation. A family business posse to build a strong foundation of a business of that the next generation is at an ease to run the business with no external influence. The principle of family inheritance is followed. Family businesses strive to keep their operations in the family only.

The foremost demand of venture capitalists is equity and ownership against their investment. Venture capitalists want the existing owners and management to relinquish control and authority in the business, so they can influence material decisions of the business. If a family business accepts investment from a venture capitalist, then it will dilute their ownership of the business. From their perspective, this dilution is a threat to the lineage of the business. Moreover, the venture capitalist might want to influence the appointment of the management as well. In a family business the children, when they come up to the right age, they become part of the business by default. Whereas, the venture capitalist will not agree with the idea to include the family members by default.

The lineage of business creates a problem for both parties. But if in the agreement a 'buy-back clause' in accordance with the provisions of the companies act 2013,5 so that venture capitalist wants to liquidate their investment, they can do that and the family business will acquire equity back from the venture capitalist. Hybrid Instruments like convertible debentures and convertible preferred shares can be used by the parties to reach a creative and acceptable solution. Moreover, the existing shareholders have a right of pre-emption6 and it has been held numerous times that the existing shareholders must be given the first option by the company.7

5) Exit option for Family business and Venture Capitalist

An investment is always done keeping in mind the options of the exit of it. The definition of a venture capitalist includes the concept of cashing out on their investment to gain considerable gains. Exit options are very important for venture capitalists. Venture capitalist starts planning their exit options since day one of investing in the company. One of the main points of negotiation for the venture capitalist are exit options, namely, right of first refusal, right first offer, call options, buy-back options, tag-along rights, and drag-along rights. Though these rights should be mentioned in the articles of association of the company, so that there are

5) Companies Act 2013, s. 68 & 70
6) ‘Pre-emption is a right to the offer of a thing being sold and not a right to the thing itself’ Bishan Singh v. Khazan Singh (1958) AIR 838
no encumbrances in the future pertaining to their exit strategy. Moreover, the courts have upheld the enforceability of all private arrangements including right of first refusal and right of first offer. These rights cannot be solely enforced on the basis of shareholders’ agreement. Venture capitalists plan their exit strategy in such a way that no party can object to it. Though it is to be noted that the agreement facilitating these rights should not be violative of the articles of association of the company. They make sure that their desired exit strategy is without any encumbrances and unwanted influences. Moreover, they want authority to decide at any given time whether to liquidate or not if any opportunity comes. Venture capitalists do not want their exit opportunity to rely upon any other shareholder of the company. They prefer to hold minority shareholdings in India. Along with minority shareholding, venture capitalists use tag-along rights in the share purchase agreement. Moreover, they add the right of first refusal and the right of the first offer to stronghold their position in the company. Venture capitalists tries to protect their interest from every angle possible. The traditional leveraged buyout model is difficult to apply in India due to various legal constraints. Therefore, Venture Capitalists have developed a hybrid model which facilitates India’s complex regulatory and governance environment.

Whereas, family businesses in India do not allow any interference in the management of the company as well as the ownership of the business. Further, a family business is established for perpetuity. They never look for an option to cash out or establish an exit strategy. The management of the business always wants their family name to be associated with the business name. It is their belief and practice in India which allows them to build a close relation and trust between the customer and management of the business. A prime example is the TATA Group. In India, management tends to include family values in business practices. For example, Indian values of treating everyone as a family member are included in the business as treating the customer as God.

Family business wants their lineage to continue the business, whereas venture capitalist wants to capitalise their investment by exiting the company for a considerable amount. The option of buyback for the family of the business is a great option. Moreover, the venture capitalists in India follow a hybrid method of investment, where they prefer to hold minority shareholding in the business. This results into a perfect combination where the management of the family business does not want to relinquish control over the operation of the business and venture capitalists does not want to interfere in the day-to-day operation of the business.

6) Conclusion
The union of the family business and a venture capitalist is very difficult. Theoretically, a collaboration between the two parties seems wrong. If there is a union between the two entities, then it is most probable that a dispute will arise between them, or else the contract will be terminated early, or their collaboration will not prove to be as effective as it should be. There are

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9 World Phone India Pvt. Ltd v. WPI Group (2013) 178 Comp Cas 173 (Del.)
10 Vodafone International Holdings BV v. The Union of India (2012) 6 SCC 613
attributes and features of family business such as strong foundation, the lineage of continuing the business, trustful management amongst each other, and attributes of the venture capitalist such as industry knowledge, vast business experience, huge funding, which when put together can lead to endless possibilities. The union of an Indian family business and venture capitalist is only possible through a very complex and custom contract. The contract must fulfil every possible situation which must arise in the future. There should be a right of first refusal in the contract so that when the venture capitalist relinquishes their ownership, the family members should have option to regain the full control of the family business. Moreover, there be a clause where the owners of the company should not object to the inclusion of family members in the family business. Through, venture capitalist wants the freedom to exit the business at any point in time. The contract must provide enough power to the venture capitalist so that they can affect the material operations of the business and decisions. On paper, the collaboration of both the parties seems unachievable. This union requires a complex and a hybrid agreement between the parties and a lot of willingness to work together. There are numerous elements which both the parties would want to include in the agreement. The union of both of them is difficult to achieve, though if achieved there can be a great feat for both parties.

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