

**WORKSHOP ON INVESTMENT
BANKING by WIRC**

TERM SHEETS AND SHA

3rd October 2015

OVERVIEW

- PART I – General concepts
- PART II – Preliminary Agreements
- PART III – Transaction – Commercial Considerations
- PART IV – Joint Ventures / Shareholders Agreements

PART - I
GENERAL CONCEPTS

LIFE OF A COMPANY

BIRTH

- Promoter
- Angel Seed Investors

TODDLER

- VC/Mergers / Acquisitions
- Strategic Alliances

Teens

- Mezzanine Debt
- Strategic Alliances

Adulthood

- IPO and Post IPO Financing

TYPES OF AGREEMENTS

PRELIMINARY AGREEMENTS

- TERM SHEET / LOI
- FRAMEWORK AGREEMENTS

DEFINITIVE DOCUMENTS

- SSHA
- SPSHA
- SSPHA
- SSA + SHA
- SPA + SHA
- JV
- Inter se Agreements

PART - II
PRELIMINARY AGREEMENTS

TERM SHEET

- Term sheet is a document which is signed after the initial discussion with the investor
- The term sheet is not binding upon any of the parties
- It is more like a declaration of intention to sign the agreement
- After signing of a term sheet, deal may actually close, but it is not guaranteed

MOTHER OF ALL DOCUMENTS

- Key Questions
- Heads of Terms
 - Advantages
 - Disadvantages
 - Legal status
 - Binding Terms

TERM SHEETS / LOI – contd.

- Exclusivity Agreement
 - Breach
- Break Fees
- Confidentiality Agreement
- Basic Features
- Disclosure
- Key Provisions
- Excluded information

KEY QUESTIONS

- Do you need a preliminary agreement? If so, which kind?
 - Heads of Terms
 - Exclusivity Agreement
 - Confidentiality Agreement
- Should the terms be binding or non-binding? Be careful of certain jurisdictions, common law v. civil law.
- How will the preliminary agreement impact on the subsequent negotiation and the final agreements?

TERM SHEETS / LOIs – PROS v. CONS

ADVANTAGES

- Confirms a moral commitment
- Online timetable and obligation i.e. who will do what – when?
- Can help avoid later misunderstanding of verbal discussions
- Get the parties focused at the beginning so that they have an idea of how subsequent negotiations may turn out (i.e. whether problematic or not)
- May highlight need for third party consents or alerts parties to tax advantages/disadvantages of basic deal structure

DISADVANTAGES

- Can limit room for manoeuvre in subsequent negotiations
- Can cause delay and additional costs
- Can inadvertently create legally binding obligation or duty to negotiate in good faith in cross-border transaction
- May have several regulatory consequences
 - Tax
 - Competition

LEGAL STATUS

- “Subject to contract” wording
- Need for clarification – merely referring to intention to conclude a more formal document later may not be sufficiently to prevent becoming binding
- Better to spell out expressly which provisions are legally binding and which are not
- Pre-contractual statements

BINDING TERMS

- Where legally binding, normal rules apply:
 - Terms must be sufficiently certain
 - Must be consideration for the promise
- Examples:
 - Lock-out/break-fees/confidentiality/non-solicitation of the seller’s customers and /or employees
- Breach may give rise to damages for wasted costs

NON-BINDING TERMS

- Examples of non-binding terms:
 - Nature of acquisition (shares/assets)
 - Price and form of consideration
 - Condition
 - Timetable
 - Warranties and indemnities
 - Employees
 - Responsibility for drafting documents
 - Costs

PRE-AGREEMENT CONCEPTS

- Due Diligence
- Component Parts
 - Property
 - Contracts
 - Statutory / Regulatory Approvals
 - Stock/WIP/Finished Goods
 - Debtors and Creditors
 - Plant and Machinery
 - Leasing HP and Finance Contracts
 - IP
 - Employees
 - Pensions
 - Environment
- Tax

DUE DILIGENCE – Contd.

- Time and resource = Cost!
- Data Room – practical aspects
 - Electronic information
 - Download/print access
- Confidentiality

“Do Things Right At The Outset!”

LEAD THE DILIGENCE PROCESS - STAY ONE STEP AHEAD

- Single point of contact
- Materiality thresholds
- Review Diligence Questionnaire and prepare detailed response
- Avoid duplication of documents
- Increasingly difficult role of the management with conflicting loyalties
- Identification of pain points to eliminate conditions precedent

EXCLUSIVITY AGREEMENTS

EXCLUSIVITY AGREEMENTS

- Protection for buying against investor shopping / target shopping
- Prevents seller from negotiating with other parties for an agreed time
- Duration must be for a fixed period
- Obligation on seller to cease discussions with third parties, rather than an obligation for discussions with that buyer to continue/be continued
- Obligation on seller not to solicit, initiate or enter into new discussions with third parties in connection with a possible “transaction”
- Seller not to provide any information about business/company to another prospective buyer

CONSEQUENCES OF BREACH OF EXCLUSIVITY AGREEMENTS

In theory two types of remedies are possible:

- specific enforcement (equitable remedy and therefore unlikely)
 - damages for breach of contract (wasted costs only)
 - only have “teeth” if backed up with “Break Fee”.
- Difficult to enforce in India.

BREAK FEES - WHAT ARE THEY?

- Also called “failure” costs agreements, termination and/or inducement fee
- A sum payable by one party to the other towards costs incurred if the deal fails to complete for specific reasons
- It is difficult to apportion “blame”!
- How common?
- Circumstances in which break fees may apply:
 - recommendation of higher bid
 - failure to meet specific conditions (e.g. shareholder approval; financing)
 - withdrawal (difficult to define and unusual)
- Financial assistance
- Liquidated damages or penalty
- Cap

CONFIDENTIALITY AGREEMENT

WHY ARE THEY USED?

- Creates simple contractual obligation – in theory easier to enforce
- Focuses mind of seller on what to disclose
- Focuses mind of buyer that information is confidential and valuable
- Can be used to vary/extend the obligation that the law would otherwise impose

COMPOSITION

- Typically contained in a separate document
- Seller requires buyer to keep confidential certain information disclosed in the course of the transaction and to use that information only for the particular purpose for which it is disclosed
- Recipients (“Permitted Disclosure”)
 - disclosure permitted to:
 - employees on a “need to know” basis
 - professionally advisers
 - providers of finance
- Buyer usually takes responsibility for its Permitted Disclosure
- Target as a party?

Three types:

- Existence of discussion or negotiations
- Existence of confidentiality agreement and its terms/conditions
- Commercial and financial information relating to the target company

DISCLOSURE

- Seller needs to:
 - check it is free to disclose (may redact or take a view)
 - check relevance of the information
 - consider timing/drip feeding
- Law, court order or rules/disclosure requirements of supervisory/regulatory bodies = forced disclosure
- Possible obligation to take reasonable steps to consult as to content and timing of forced disclosure

KEY PROVISIONS

- Definition of confidential information
- Central obligation to keep information secret and only use it for the permitted purpose
- Restrictions on copying
- Obligation not to approach employees of the target company
- Obligation not to visit target's premises uninvited
- Obligation not to approach customers, suppliers, shareholder, advisers of the target
- Obligation to return or destroy confidential information

PART – III
TRANSACTION
COMMERCIAL CONSIDERATIONS

TRANSACTION

- Parties
- Agreement to sell
- Conditions
- Period to completion
- Consideration
 - Earn out
 - Completion Accounts
- Completion
- Restrictive covenants

- Termination

PARTIES

General

- Indemnity
- Nationality
- Multiple sellers?
- Guarantee
 - Subsidiary seller/buyer
 - Trusts

CONSIDERATION

Choices

- Shares - SWAP
- Cash
- Earn Out (as a percentage of gross sales or earnings)
- Consideration Downward Adjustment

CONSIDERATION – EARN OUT

- Management Seller
- Advantages & Disadvantages
- Turnover, Profits, EBITDA, Net Assets etc.
- Dispute resolution – Expert Appointment
- Security
- Relationship with Warranties
- Tax

CONSIDERATION – COMPLETION ACCOUNTS

- Provisional Completion Payment
- Apportionment
- Price Reduction
- Who to prepare financial statements?
- Dispute resolution – Appointment of expert
- Relationship with Warranties

COMPLETION

When?

Where?

Delivery

**Post
Completion**

RESTRICTIVE COVENANTS

- Implied restraints
- Specific restraints
 - Competing business
 - Customers
 - Employees
 - Confidential information
 - Use of name
- Enforceability

TERMINATION

- Conditions
- Repetition of Warranties
- Changes in Business
 - Rescission
 - Damages
- Thresholds
- Watch out for the MAC

WARRANTIES

- “Caveat emptor”
- What are Warranties? Diligence Process as warranty
- Two purposes:
 - allocate risk between buyer and seller
 - elicit information from seller
- Breach of Warranty = breach of contract
- Terms
 - Conditions
 - Warranties
 - “innominate” terms
- Termination
- Damages
- Equitable remedies (injunction, specific performance)

KEY WARRANTIES

Accounts

No material adverse change since accounts date

Litigation (contingent liability)

Change of Control

Title to Shares/Assets

Sweep-up warranty

Authority to enter

Tax indemnities

Environmental

IP

INDEMNITIES

- Compensation
- When are indemnities used
 - specific matters raised in disclosure/diligence
 - tax indemnification
- Is an indemnity appropriate?
- Who has conduct of claim?

DISCLOSURE LETTER

INTRODUCTION

- Disclosure letter – 3 components:-
 - “general” disclosures
 - “specific” disclosures
 - schedule of documents and bundle of documents
- Addressed from seller (rather than its lawyers)
- No disclosure against tax indemnity

OTHER POINTERS

- Disclosure of data room
 - generally, do not accept
- Disclosure of web site
 - take care: “certainty” is the keyword
- Cross-reference disclosure to warranties
- Do not use disclosure to rewrite the warranties
- Key to disclosure – “fair”

“GENERAL” DISCLOSURES

- Correspondence between parties and between advisors
 - Identify specific correspondence
- Property/ IP Search
- Matters of public record
 - Never accept!
- Matters of which the buyer ought to be aware
 - Never accept!

PART - IV

JOINT VENTURES / SHAREHOLDERS ARRANGEMENTS

SHARE PURCHASE AGREEMENT

- Short!
- No termination rights
- Warranties – increasingly limited to title
- Limited tax indemnities
- Specific indemnities for issues arising out of due diligence – “price into bid”
- Disclosure
- Governing law and Jurisdiction – possibly UK law or law of the specific European jurisdiction will be insisted upon (both for arbitration and litigation).

Note: This may mean higher costs and professional fees as compared to when the governing law is Indian and the dispute takes place in Indian Courts.

WINNING HANDS

- Certainty of
 - Timing
 - Money
 - Ongoing liability for seller

SHARE HOLDER'S AGREEMENT

- Contractual agreement between some or all of the shareholders.
- Part of the constitution of the company.
- A private document.
- Not mandatory under Indian Law.
- Binding only upon the parties to the agreement.
- A contractual remedy available to a shareholder in the event of any breach of any covenant or representation by the other shareholder.
- An agreement governing aspects of relationship of the parties not covered under the MoA and AoA and to suit specific requirements of the shareholders.

TO WHOM BENEFICIAL

- Private Equity Investors
- Angel Investors
- Joint Venture Partners
- Employee Shareholders
- Founders

BENEFITS OF SHARE HOLDERS' AGREEMENT

- Works in conjunction with the company's AoA, but will give shareholders greater protection than can't be provided by the articles alone.
- Existence of a shareholders agreement can assist in raising finance from banks or creditors and also demonstrates the stability of the business to other potential partners.
- Protects the rights of minority shareholders and the investment value of their shareholding.
- It is a cheap way to minimise any potential for business disputes between shareholders

TYPES OF SHAREHOLDERS AGREEMENTS

- Pre incorporation/formation Agreement
- Share subscription and Share holder's Agreement
- Private equity Transactions
- Institutional Venture Capital
- Joint Funds
- Seed series

TERM

- No limits specified under Indian law to restrict term of shareholders' agreement.
- Term is at the discretion of the shareholder's entering into the agreement.

OBJECTIVES

- Appointment of directors and quorum requirements.
- Determining matters requiring special resolution.
- Providing veto rights to certain shareholders.
- Funding of the company:
 - Shareholders' loans
 - Borrowing power of the directors
- Defining obligation of each of the share holder towards the company.

CORPORATE STRUCTURE

- Getting organized
- Governance
- Capital structure
- Price paid for shares acquired
- Strings attached?
- Issued vs Authorized common shares
- Stock vs Stock options
- Common mistake
 - Lack of attention to future tax consequence

ROLES OF PROMOTER

- Day to day management of the company.
- Ensure that business is operated and managed in accordance with the business plan, applicable laws, service contracts etc.
- Assisting company in procuring all necessary approvals, consents from all relevant authorities as required under applicable law.
- Making their expertise and necessary human and technical resources available for the operation and management of the company.
- Utilization of Subscription amounts.

FUNDING OF THE COMPANY

- Equity Capital
- Pre-emptive rights for issues of new securities
- Anti dilution rights
- No more Favourable Rights

Board of Directors

- Composition
 - Appointment/replacement
 - Nomination by shareholders
 - Voting rights
 - Alternate directors
 - Vacancy
 - Chairman
 - Board meetings
 - Directors' fees and expenses
-
- Qualification shares
 - Quorum/Quorum not present

DECISION MAKING

- Reserved matters
- Voting generally
- Shareholders meetings
 - General meeting
 - Notice of shareholders meetings
 - Quorum

 - Practical issues
 - Oppression and Mismanagement u/s 397 / 398 of the Companies Act, 1956

MANAGEMENT

- Day-to-day management – CEO and Reporting
- Auditors
- Audit committee
 - Constitution
 - Meetings
 - Participation by electronic means
 - Reporting to the board
 - Any delay in appointments
- Appointment of Independent Directors
- Appointment of CFO/ Financial Controller and MIS Manager
- Appointment of Chief Operating Officer and Project Manager Team
- Business Plan

COVENANTS

- Undertakings of the Promoter and the Company
 - Non-compete obligation
 - Company Investments / Buy-Backs
 - Promoter's non-disposal
 - Employment
- Insurance
- Further borrowings and maintenance of debt/equity ratio
- Exit options

COVENANTS

- Information rights:
 - Financial records
 - Investor shall be allowed access to examine books and records of the company
 - Minutes of all Board meetings and shareholders' meeting
 - Annual Business Plans
 - Draft annual budget
 - Details of any material litigation
 - Any other information or report as may be reasonably required by the Investor

DIVIDEND POLICY

- Declaration and payment of interim dividend
- Preferential dividend

TRANSFER OF SHARES

- Transfers in violation of agreement
- Non-disposal of shares
- Transfers by the Promoter and the Investor
- Right of first refusal
- Drag-along and Tag-along rights
- Other restrictions on transfer of shares
- Shareholder group
- Transmission of shares
- Promoter call option

ARBITRATION

- Time line for dispute resolution
- Selection of arbitrators

CONFIDENTIALITY

- Non disclosure of confidential information

TERMINATION

- Under what circumstances is the agreement terminated?
- Are there any penalties?
- Events of default
- Consequences upon termination and default
- Default by investor and consequences
- Violation of terms
- Ceases to be a shareholder
- Termination in the event of death of a shareholder

REPRESENTATION, WARRANTIES AND COVENANTS

- Duly registered
- Has the legal capacity to enter into and perform obligations under this agreement
- Carry out the transaction contemplated by this agreement
- Agreement is valid and binding
- There is no violation of any provisions of constituent documents
- Joint and several representation and warranties

INDEMNIFICATION

Indemnification against claims, losses, damages, expenses, costs and other liabilities.

RELATIONSHIP

No party shall act as an agent of any other party or have any authority to act for or to bind any other party except as provided in the agreement

DEED OF ADHERENCE

- Required to become a party to a shareholders' agreement entered into before obtaining shares.
- An agreement pursuant to which a new shareholder agrees and adheres to the terms and conditions of the Share Holders' agreement.

BOILERPLATE

Announcement

Assignment

Costs

Effect of Completion

Entire Agreement

Variations

Waiver

Invalidity

Notices

Counterparts

Governing Laws/ Jurisdiction

Third Party Rights

CAUTION TO TARGET

- Do not over represent or give incomprehensible warranties
- Events of Default to be clear
- Qualifiers
- Cap on Liability
- Disclosures
- Statutory Obligations
- Extended timelines
- Caution to Start-ups – see value brought to the table.
- Don't give more rights than necessary
- Shareholding Thresholds

MANAGING THE JOINT VENTURE

Each of the parties to the joint venture is likely to want to be able to influence its ongoing management

This concern is particularly relevant where the joint venture is structured as a 50:50 “partnership”

Who will be appointed to the board of directors?

Who will have the power to appoint and remove directors from the board?

MANAGING THE JOINT VENTURE (2)

What constraints will affect the power of the board to manage the joint venture?

Who will be responsible for day-to-day management of the joint venture?

It is usual to include a list of actions which cannot be taken by the joint venture company without the approval of each of the parties in the joint venture agreement – “Veto Matters”

DEADLOCKS

- Parties may disagree over an important issue
- Chairman may be given the casting vote
- Matters may be referred to an independent expert or arbitrator, or to senior persons in the management of the joint venture
- Who blinks first?

MINORITY PROTECTION

- Protecting the interests of parties holding less than 50 percent of the equity shares
- Preventing the issue of further shares by the joint venture
- Giving the minority shareholder the right to representation on the board for certain decisions
- “Tag along rights”
- Right to information

TRANSFER OF SHARES

- Prohibiting the transfer of shares in the joint venture vehicle to a third party without consent
- Each party will wish to avoid participating in a joint venture with a third party on whom it has not carried out due diligence
- However, the parties are likely to want to restrain some flexibility
- Transfers may be allowed to other members of the same group of companies – “Affiliates”

EXIT STRATEGIES

- Each party will want to agree to an exit strategy to end the joint venture in certain circumstances
- “Lock-in” period effected by restricting the transfer of shares
- The lock-in period may be for a fixed period of time
- One party may have the right to buy out another party

EXIT STRATEGIES

- Buy-back
- Drag Along
- Strategic Sale
- IPO

EARLY TERMINATION

- In case the joint venture is not working out as intended by the parties
- Provisions of automatic termination
- Each party may retain the right to terminate if the other commits a default by breaching a condition of the joint venture agreement
- Necessary to consider provisions for the distribution of assets
- Termination without cause – to be avoided
- Consequences of termination

PRINCIPAL DOCUMENT

- Joint venture agreement
- Memorandum and Article of association of a joint venture company
- Finance agreement
- Service agreement
- Supply or service agreement between the joint venture vehicle and the joint venture parties

PROCESS

REGULATORY MATTERS (1)

- Filing, clearance and other notification Data
 - Competition (merger controls)
 - Foreign investment laws, regulations and policies
 - Central bank, Ministry of Finance/Reserve Bank of India
 - Securities and Exchange Board of India
 - Intimation of Stock Exchanges
 - Corporate governance issues (like appointment of independent directors, internal controls)
- Is filing / clearance mandatory or advisable?
 - Dependent on size of transaction?
- Who is responsible for making the filing/obtaining the clearance?

REGULATORY MATTERS (1)

- Governing factors
 - Jurisdiction in which the parties are incorporated in/resident of
 - The industry/sector in which the proposed acquisition is to be made
 - The nature of the entity i.e. company, partnership, FII
 - Whether the entity is a private or public (listed/unlisted) company

REGULATORY MATTERS (2)

- Is there a mandatory waiting period before
 - signing?
 - completion?
 - Can an agreement be entered into conditionally upon the filing/clearance
- When can the filing be made/consent applied for?
- How long will it take to obtain clearance?
- Fees payable and who is responsible for the fees?

CONDITIONS

- Common conditions:
 - Shareholder Approval
 - Approval from Statutory Authority/Government Department
 - Consent
 - Assignment/Novation
 - Anti Trust/Regulatory
 - Tax Clearance
 - Release of Mortgage or Other Charges
 - Financing/Admission
- Whose responsibility?
- Right to waive
- Long Stop Date

PERIOD OF COMPLETION

- Protection of goodwill
- Usual/ordinary course of business/trading
- Need for others?
- Buyer's access
- Link to warranties
- Material Adverse Change

PITFALLS

INDIAN LEGAL ISSUES

- RBI guidelines and regulations regulating acquisition and transfer of foreign securities and other current and capital account transactions
- Prohibition on certain investment, e.g. real estate and retail trading, except single brand retail
- Up to 400% of the net worth of the Indian company can be invested abroad without prior RBI approval
- Limit for proprietorship or unregistered partnership export firms is 200% of their net worth or 10% of the average of 3 financial years export realization, whichever is lower, with the prior approval of RBI
- Ceiling does not apply for funds maintained by Indian companies in the Exchange Earners' Foreign Currency account or funds raised through ADR/GDR offerings
- Listed Indian companies can invest up to 50 percent of their net worth as on the date of the last audited balance sheet in (i) shares and (ii) bonds / fixed income securities, rated not below investment grade by accredited / registered credit rating agencies, issued by listed overseas companies
- All other cases require prior approval from the RBI

INDIAN LEGAL ISSUES (2)

- 400% net worth limit includes guarantees and amount of guarantee has to be specified up front
- Guarantees possible only where Indian investor has equity participation
- All guarantees to be reported to RBI in Form ODI II
- An Indian investor may pledge its shares to an AD or a public financial institution in India for credit facilities
- The pledge may also be carried out with an overseas lender, provided the lender is recognised and regulated as a bank
- Resident entities having overseas direct investments can hedge foreign exchange rate risks arising, and ADs can enter into forward/option contracts with Indian investors who wish to hedge

THANK YOU
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For questions please contact
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