Purchase Price Adjustments in Court Schemes

Price adjustments in M&A transaction documentation enable parties to align the consideration originally negotiated at signing to the facts and circumstances existing at closing. Such adjustments become particularly important when there is a protracted time gap between signing and closing, usually due to statutory and regulatory approvals, and in case of listed entities, volatility in the financial markets. Certain transactions are implemented through tribunal-approved schemes of merger, de-merger, etc. ("**Schemes**"). While Schemes offer certain advantages such as an exemption from takeover regulations in case of listed entities, price adjustments in such transactions are subject to greater scrutiny and constraints, given requirements for tribunal approval and in the case of listed entities, pricing requirements and review by stock exchanges and the securities regulator. Accordingly, this note sets out certain price adjustment mechanisms that could be considered by parties to Schemes involving listed entities.

THE IMPLEMENTATION CHALLENGE WITH RESPECT TO SCHEMES

In India, Schemes are governed by the Companies Act, 2013 (the "**Act**") and are required to be approved by the relevant bench of the National Company Law Tribunal (the "**NCLT**"). If one of the entities involved in the Scheme is listed, regulations and circulars issued by the Securities and Exchange Board of India (the "**SEBI**") and the stock exchanges in India will also apply.

Pursuant to SEBI regulations, the listed entity is required to obtain an independent valuation upfront at the time of announcement of the Scheme (except where there is no proposed change in the shareholding pattern of the listed entity). Where the Scheme contemplates allotment of shares to a select group of shareholders or shareholders of unlisted companies, pricing guidelines applicable to preferential allotments by listed companies are required to be followed, based on specified look-back periods from the date on which the board of directors of the listed entity approves

the Scheme (the "**Relevant Date**"). The swap ratio or consideration for the Scheme would therefore be calculated with reference to the Relevant Date, and absent any adjustment mechanism, would remain the same until the date of implementation of the scheme (the "**Effective Date**").

In Schemes involving listed entities, SEBI/stock exchange review is required to be completed prior to filing of the Scheme with the NCLT, which could take two (2) to three (3) months. The NCLT process involves two stages – first, convening of shareholder and creditor meetings of the transferor and transferee companies, and second, sanction of the scheme after hearing representations/objections from regulators and statutory authorities (including the Regional Director/Registrar of Companies and tax authorities), which could overall take six (6) to nine (9) months or longer, depending on the NCLT bench. If the transferor and transferee companies are subject to the jurisdiction of different NCLT benches, the parties would need to obtain sanction from all applicable NCLT benches. Although the Act provides a 30-day time period for regulators to provide representations/objections to the Scheme, it does not specify a deadline within which the NCLT must sanction a Scheme.

Certain Schemes may also require approval of the Competition Commission of India ("**CCI**"), which can usually be initiated simultaneously with the SEBI/stock exchange process. Companies in regulated sectors such as telecommunications and insurance may be required to seek prior consent of the relevant regulator for transactions contemplated by Schemes. If the Scheme requires foreign investment approval, the application for foreign investment approval can be filed only *after* the NCLT has sanctioned the Scheme (and not simultaneously with the NCLT process). Although the Government has endeavoured to process foreign investment applications within 10 weeks, as a practical matter, the process could take four (4) to six (6) months or longer. Such approval requirements also contribute to the time gap between the Relevant Date and the Effective Date.

In private transactions, parties could agree a purchase price upfront at signing, and then implement a post-closing adjustment mechanism to account for the difference between the initial purchase price and the purchase price determined on the basis of information available on the closing date. In respect of Schemes, given the approvals required, the time gap between the Relevant Date and the Effective Date is likely to be significantly longer than in private transactions. Further, unlike in private transactions, the swap ratio or consideration specified in a Scheme is reviewed and approved by the SEBI, stock exchanges, the NCLT and possibly other regulators, and the parties will then need to consider whether they need to seek approval again to effect any adjustment in the swap ratio or consideration – if so, re-starting the approval process

will defeat the purpose given the timelines involved. Accordingly, set out below are certain price adjustment mechanisms that parties could consider including in Schemes at the outset to retain flexibility for addressing the time gap and potential change of circumstances between the Relevant Date and the Effective Date.

ADJUSTMENT MECHANISMS

1. Adjustments based on pre-completion or completion accounts

An adjustment mechanism implemented closer to the Effective Date will allow for the swap ratio or consideration determined at the Relevant Date to be modified for agreed financial parameters (such as net debt or working capital) on the basis of financial statements prepared by the relevant entities and reviewed/verified by the counterparty. Since return or issuance of shares for nil consideration following the Effective Date may not be feasible in view of Indian foreign exchange control regulations, regulations applicable to listed companies and tax considerations, and return of cash to non-resident entities is not expressly permitted in the context of Schemes under Indian foreign exchange control regulations, the parties could implement the requisite adjustments and determine the final swap ratio or consideration prior to the Effective Date. Therefore, this mechanism typically provides for financial statements to be exchanged and verified, and the revised swap ratio or consideration to be calculated, at such point of time prior to the Effective Date when it is relatively certain that the Scheme will be implemented – e.g., the timing of the adjustment could be linked to the receipt of the last regulatory approval.

To facilitate such adjustment in the swap ratio or consideration closer to the Effective Date, the parties should: (a) explore at the outset with the valuer if it is possible for the valuation report to provide for a range instead of a fixed swap ratio or consideration; and (b) specify in the Scheme that the final swap ratio or consideration will be subject to pre-closing adjustments as agreed among the parties. This will provide flexibility to the parties to effect their agreed adjustments.

Based on the residency of the parties involved and tax and other considerations, if it is possible to provide for the adjustment after the Effective Date, the above mechanism could be applied based on completion accounts within a specified time period following the Effective Date.

2. Capital infusion or extraction of cash to maintain agreed swap ratio or consideration

As an alternative to adjusting the swap ratio or consideration, promoters could agree to infuse additional equity or extract surplus funds from the relevant entity prior to the

Effective Date such that the swap ratio or consideration agreed at the Relevant Date remains commercially viable at the Effective Date.

Given the potential for change in number of shares of the entities involved, the swap ratio could be expressed as a percentage instead of a numerical ratio, i.e., [x]% of the equity share capital of the transferee company to be issued to the shareholders of the transferor company, rather than as [x] equity shares of the transferee company for every one equity share of the transferor company. Further, the parties will need to ensure that the Scheme does not restrict the relevant entities from issuing additional shares, declaring dividend or undertaking any other action that is envisaged to maintain the agreed level of debt (or other financial parameter). The disclosure of such transactions in the Scheme would enable upfront approval from shareholders, creditors and relevant authorities.

Similar to item (1) above, the quantum of funds to be remitted to or extracted from the relevant entities could be based on financial statements prepared, exchanged and verified at such point of time prior to the Effective Date when it is relatively certain that the Scheme will be implemented. This will also mitigate the risk of any requirement to unwind the remittance or extraction in case the Effective Date is not achieved.

3. Inter se payments

In order to implement the Scheme on the basis of the financial parameters as of the Relevant Date, the merger agreement could provide for payment of such amount by the relevant entity (or its promoters) to the resulting / target company (e.g., for breach of their obligation to maintain agreed debt levels (or other financial parameters)), which will have the effect of restoring the resulting / target company to the position it would have been in had such breach not occurred.

Any such payments should be disclosed in the Scheme, and parties will need to consider the impact of Indian foreign exchange control regulations and tax and other considerations while structuring such payments. For example, payments by resident Indian entities to non-resident entities in the context of Schemes may require prior approval of the Reserve Bank of India, which would need to be sought independently and cannot be obtained through the Scheme process. Further, such payments could become contentious, and in such cases, recovery would be subject to the outcome of the agreed dispute resolution process.

4. Inter se share transfers

Promoters of the entities involved in the Scheme could undertake *inter se* transfers of shares of the resulting / target company at or following the Effective Date to achieve

the intended commercial result – these transactions should be disclosed in the Scheme to ensure approval by the shareholders, creditors and relevant authorities and would also be entitled to available exemptions for Schemes (e.g., under takeover regulations). In case of transactions involving non-residents, pricing guidelines will need to be considered for off-market share transfers (price will be a floor or a cap equal to the share price determined on the basis of prescribed look-back periods). On-market transfers will be subject to limitations based on the prevailing market price (e.g., block deals on the exchange are permitted within a range of ±1% of the prevailing market price). Tax implications will also need to be considered.

5. Standstill and other covenants

In order to preserve the value of the businesses that are the subject matter of the Scheme, parties will typically agree a set of standstill covenants that will apply between the Relevant Date and the Effective Date. These will require the entities involved in the Scheme to *inter-alia* conduct their business in the ordinary course and seek consent of the counterparty for undertaking certain actions such as incurrence of capital expenditure or debt beyond agreed levels.

In addition, parties could also agree to covenants requiring, for example: (a) the entities involved in the Scheme to borrow funds only from their respective promoters if they wish to incur debt above agreed levels between the Relevant Date and the Effective Date; (b) such promoters to waive such debt (to the extent such debt exceeds agreed levels) following the Effective Date; and/or (c) such promoters to discharge the debt or debt-like items (to the extent such debt exceeds agreed levels) following the Effective Date.

Note that the efficacy of such provisions will depend on the willingness of the relevant entity (and its promoters / shareholders) to adhere to them, and therefore parties should negotiate additional protection for themselves through one of the other mechanisms described above.

Parties will also need to ensure that the above covenants do not constitute acquisition of control by the counterparty or envisage the relevant entities acting as one prior to obtaining CCI (anti-trust) approval. Therefore, anti-trust lawyers should closely review the standstill covenants to mitigate the risk of these being viewed by the CCI as pre-transaction coordination between transacting parties aimed at circumventing anti-trust laws (i.e., ‘gun-jumping’).

CONCLUSION

Schemes are reviewed closely by regulators, including the SEBI, stock exchanges and the NCLT as well as by shareholders, creditors and proxy advisory firms. Regulators may also monitor compliance with the Scheme – for instance, the Act requires notifications regarding compliance with the NCLT's orders in respect of the Scheme to be filed with the relevant Registrar of Companies on an annual basis until the completion of the Scheme. Therefore, while parties will set out their adjustment mechanisms in detail in the merger agreement or contract, the Scheme and related documents should also contain adequate disclosure regarding such mechanisms – the level of such disclosure will vary depending on the facts and nature of the Scheme and comments received from regulators. Parties should remain aware that the merger agreement or contract will be open for inspection by the shareholders and creditors as part of the NCLT process. Further, authorities such as the NCLT may also require the parties to file the merger agreement as part of the approval process. Additionally, if the signatories to the merger agreement include entities listed on stock exchanges outside India, the merger agreement may need to be filed with such offshore stock exchanges or securities regulators. Therefore, even though Indian stock exchanges currently do not require copies of agreements to be filed for disclosure purposes, however, given the above, parties should assume for all practical purposes that details of their adjustment mechanisms will be publicly available.

As described above, the type of adjustment mechanism to be adopted in a Scheme will depend on several factors, including the expected time gap between the Relevant Date and the Effective Date, residency of the parties in or outside India (which will determine the applicability of Indian foreign exchange control regulations) and tax considerations.

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