Managing Foreign Sellers' Risks in Indian M&A Transactions

In a previous note published earlier this month, we discussed certain common risks for foreign buyers in Indian M&A transactions and strategies to mitigate such risks. In this note, we have considered the most common concerns of foreign sellers in an M&A transaction i.e., to mitigate risk of deal certainty, risk of any payment default by buyer and limitation of foreign sellers' liability post completion of an M&A transaction, and discussed certain trends and market practices relevant for foreign sellers to manage such risks within the Indian legal framework.

KEY RISKS AND MITIGATION STRATEGIES

Deal break

An M&A transaction may fail to close for various reasons wherein either party (i.e., the buyer or the seller) backs out of the transaction. Usually, an M&A transaction is a complex process involving a considerable amount of time and expense from both sides, including but not limited to costs incurred in evaluating a transaction, including due diligence, fees paid to lawyers, accountants, investment bankers and so on. If a deal falls through, either party may suffer reputational harm which may also impact future deals on account of the parties being seen as unreliable or unwilling to commit to transactions.

Usually, a 'break fee' or 'termination fee' is incorporated in the transaction documents to provide protection to the buyer against the seller from dishonoring the deal for the reasons set forth under the transaction documents including a breach of any exclusivity period. However, if the buyer breaks the deal, it poses a risk to the seller which needs to be mitigated. While specific performance as a contractual remedy is common in Indian M&A transactions, in certain situations, foreign sellers may look for additional remedy if the reason for termination includes the buyer being unable to arrange transaction funding or if the buyer fails to obtain corporate or regulatory approvals. A 'reverse break fee' requires the buyer to pay the seller a termination fee in case the transaction fails to close for reasons set forth in the transaction documents. While 'reverse break fee' is common in

government disinvestment transactions in India, we are increasingly seeing such clauses also being included by foreign private equity funds in exit transactions. In certain transactions foreign sellers have also managed to include a 'reverse break fee' in Indian M&A transactions where they anticipated a real risk on account of a possible change in business strategy or priorities impacting the buyer, including a change in ownership of the buyer before completion of the transaction.

It should be noted that the quantum of a 'termination fee' in India, is governed by the [Indian] Contract Act, 1872, and should be a genuine pre-estimate of the loss suffered and such an amount cannot be excessive or unconscionable. We have typically seen a range of 1 to 3% of the deal value as 'reverse break fee'. Additionally, any 'reverse break fee' to be paid by resident buyers to foreign (non-resident) sellers will require prior approval of the Reserve Bank of India ("**RBI**").

Receiving the consideration amount

A key concern all sellers have in M&A transactions is to timely receive the consideration amount including any deferred consideration amount. Various reasons may be attributed to the non-payment or delayed payment of the consideration amount such as the state of buyer's cash reserves, external financing issues or change in strategy of the buyer. While it is not common for buyers in Indian M&A transactions to agree to give representations on availability of funds, in transactions where there is high interest in the target, foreign sellers have been able to insist on protection in transaction documents to confirm availability of funding of the buyer. Increasingly foreign sellers have also been insisting on confirmation of compliance with relevant anti-money laundering and other laws in availing funding.

If the transaction also involves a certain part of the consideration amount being deferred, it increases the credit risk that foreign sellers need to take on buyers and the continued availability of funds to them. In a recent transaction, that required deferred consideration to be paid by a private equity buyer, the seller insisted on receiving an equity commitment letter from the private equity fund to get comfortable on the availability of funds when required. Another strategy that could be adopted by the parties to protect payment of deferred consideration is the creation of an escrow account. Generally, an escrow account is set-up by a third-party bank that will hold the funds which might be exchanged in an M&A transaction between the buyer and seller to ensure that both the parties fulfill their respective obligations. In most cases, such assurance is needed by the buyer from the seller to confirm that the representations and warranties made by the seller are true and correct or other agreed conditions linked to the release of the deferred consideration amount have been completed. However, such an escrow mechanism could also be used by foreign seller as an assurance from the buyer that the cash consideration stipulated

under the transaction documents will be discharged by the buyer upon fulfilment of all necessary obligations of the foreign seller.

As discussed in our previous note published earlier this month, the deferred consideration amount will also be subject to India's exchange control rules.

Share swap

A foreign seller may choose to receive consideration by way of swap of shares in the acquiring company in exchange for shares in the target company. However, there might be instances where such swap of shares is not effectuated on account of factors such as the buyer's financial condition, pending litigation matters, employee or regulatory matters etc., thereby becoming a risk factor for the foreign seller. Many times in share swap transactions, foreign sellers while accepting a diligence to be carried on the target company, take a commercial call not to undertake diligence on the buyer, on account of the buyer being a larger entity, a listed company or having been through multiple investment rounds. Relying on diligence undertaken by other entities or assuming financial stability of the buyer, even if it is perceived to be a larger entity, has got many sellers in trouble. As a mitigation strategy, in addition to the due diligence undertaken by the buyer on the target company, foreign sellers should also consider conducting a due diligence on the acquiring company which would attempt to ascertain the buyer's financial capability, business and personal reputation, and the reasons for the buyer's interest in the acquisition. Additionally, a detailed set of representations and warranties commensurate with the level of equity being received by foreign sellers and backed by appropriate indemnity should be received by foreign sellers.

Foreign sellers may also face fluctuation risk in the value of swap shares since a fall in the prices of the buyer's shares at the time of transfer will result in lower valued shares being received by foreign sellers due to a pre-agreed exchange ratio and an adjustment formula may be negotiated to factor such risk. However, in case of a foreign seller, the swap ratio and any adjustment thereof will be subject to the pricing guidelines prescribed under India's exchange control rules and will also have to be supported by a valuation report.

Breach of representations and warranties and indemnity

Foreign sellers are expected to provide certain representations and warranties in M&A transactions to the buyer in relation to the title on shares and company's business, assets, liabilities, corporate status and operations, etc. In case of breach of such representations and warranties, foreign sellers are required to indemnify the buyer for the losses resulting from such breach. Such event of breach and resultant indemnification thereby becomes a risk factor for foreign sellers and subjects them to claims arising after closing of the transaction (including on account of any retrospective tax liabilities) and may impact usage

of sale proceeds, distribution of funds and closure of funds for private equity investors. Foreign sellers typically deal with such risks through the following:

1. **Qualifiers:** Foreign sellers can limit their liability by narrowing the scope of representations and warranties through knowledge and materiality qualifiers.

    a. Knowledge qualifiers: Through a knowledge qualifier, the reach of certain representations and warranties can be limited to only what the seller 'knows'. While a buyer may expect knowledge qualifiers to extend to constructive knowledge, i.e., knowledge which can be reasonably obtained and is expected of the seller to be aware, it is common for foreign sellers to limit it to actual knowledge and in certain cases attribute it to actual knowledge of certain identified key managerial personnel.

    b. Materiality qualifiers: Another way of limiting claims for foreign sellers is by qualifying representations and warranties with material facts or conditions. Materiality in this context could include a monetary threshold or by way of percentage of revenue or assets. In this manner, the seller demarcates these thresholds to ensure that they are not liable for breaches for non-significant deviations.

2. **Limitations on liability:** Foreign sellers can also limit their liability by including indemnity caps and survival periods for breach of representations warranties.

    a. Aggregate cap: By including an aggregate cap on indemnity claims, a foreign seller can limit its financial exposure to indemnification by imposing a maximum amount which a party may be obligated to pay for indemnifiable losses for all the claims combined (regardless of the actual loss incurred by the buyer). The market practice in India on aggregate caps being insisted by foreign sellers typically ranges from 15% to 25% of the deal value depending upon the type of transaction, deal value and the identity of the buyer and seller. An indemnity payment by a foreign seller to a resident buyer that exceeds 25% of the deal value will require prior approval of the RBI.

    b. De minimis: Through a de minimis clause, a pre-determined monetary threshold must be exceeded before the buyer can pursue claims against the foreign seller for losses arising out of breach of representations and warranties. This protects foreign sellers from minor claims for compensation, which are immaterial compared to the agreed deal value. At the same time, the de minimis clause helps to avoid innumerable legal disputes between the parties over minor amounts. The market practice in India on de minimis typically ranges from 0.01% to 0.05% of the deal value.

    c. Basket: Baskets and de minimis clauses are frequently clubbed together in transaction documents. The claim items in this process are initially pooled, and only

after the agreed-upon threshold is surpassed, reimbursements or claims may be made. Symbolically, all claims are placed in a basket, and they can be processed as soon as the basket is filled. The basket cap is usually agreed between five to ten times the de minimis amount.

d. Survival period: Foreign sellers may choose to impose a contractual limitation on how long the buyer will be able to make indemnity claims for breaches of representations and warranties after the closing of the transaction. Such survival periods for foreign sellers generally range from 12 to 18 months after the closing for breaches other than for breach of certain fundamental representations and warranties and tax claims, which could be longer.

3. **Representations and Warranties Insurance ("R&W Insurance"):** R&W insurance can be beneficial for foreign sellers in Indian M&A transactions. Private equity funds with limited fund life in particular have been insisting on buyers seeking R&W Insurance rather than relying on indemnity from such funds for protection of unknown risks arising from breach of any representations and warranties. The benefits of R&W Insurance to foreign sellers include being able to get a clean exit from the target without post-completion risks and liabilities.

CONCLUSION

Foreign sellers seeking an exit/sale in India are many times focused on ensuring deal certainty and protection from any continuance of post-completion liability. Effectively discussing and negotiating appropriate protection in transaction documents in the manner discussed above in this note is necessary to ensure such risks are minimized.

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