Understanding the Strategic Sale Agreement

1. What is Strategic Sale?

In the strategic sale of a company, the transaction has two elements:

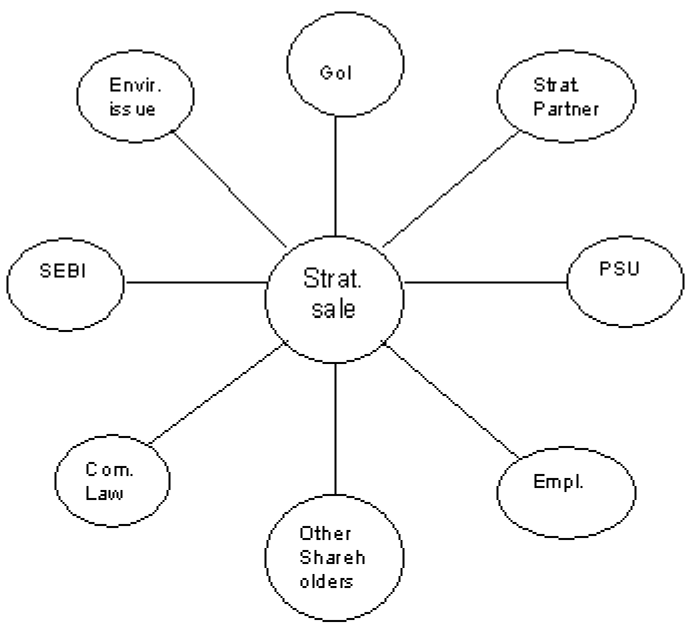
- Transfer of a block of shares to a Strategic Partner and
- Transfer of management control to the Strategic Partner

2. The transfer of shares by Government may not necessarily be such that more than 51% of the total equity goes to the Strategic Partner for the transfer of management to take place. In the case of PSUs, in order that the company no longer has the character of a Government company, the transfer of shares involves bringing down Governments shareholding below 51%. In fact, it must be remembered that Companies Act, 1956 only defines a 'Government Company', which in common parlance, is a company in which Government holds more that 51%. PSU is not defined in the Act. Once the Governments shareholding goes below 51%, it ceases to be a Government company and hence, it requires changes in the Articles of Association of the company especially in relation to the Presidential directives etc. The Strategic Partner, after the transaction, may hold less percentage of shares than the Government but the control of management would be with him. For instance, if in a PSU the shareholding of Government is 51% and the balance is dispersed in public holdings, then Government may go in for a 25% strategic sale and pass on management control, though the Government would post-transfer have a larger share holding (26%) than the Strategic Partner (25%). It may be noted here that the number 26% has a special significance in Company Law as to get a special resolution passed, one requires at least ¾ majority in a general meeting. Therefore, the 26% block acts as a check. Special resolutions are required under law in case of certain critical decisions by the company such as reduction of capital, alteration in Articles of Association and Memorandum of Association, winding up of the company, issue of share with variation of rights of special classes of shareholders etc. (see Annexure I). As we shall see later, in case of strategic sale of PSUs, Government typically has affirmative rights on several issues, which are much wider in scope than what is provided in Company Law for special resolutions. In fact, the Agreements can be structured such that these rights are exercisable even when Government holding goes below 26%. The other critical number one encounters in Company Law are 10% shareholding, below which one loses voting rights unless specially provided.

3. Since the shareholders mutually agree to certain rights and obligations which may by dint of the Agreement between the parties assign certain special rights and obligations on the shareholders to which they would normally not be bound through the provisions of the Company Law, the Agreements assume great significance in the case of strategic sale of PSUs. However, as mentioned earlier, in case of strategic sales, the Government has to ensure that the Agreements signed with the Strategic Partner adequately safeguard the Governments/nation's interests, the interests of the company and finally those of the employees. Therefore, these documents have to be carefully structured. This paper tries to give an insight into the issues involved, the structure of the documents, standard clauses, and the reasons behind them and how they safeguard stakeholders' interests.

Environment of the sale

4.1 Before we look at the documents itself, it is worthwhile to understand who the stakeholders are and what is the environment in which the transaction is taking place. The following diagram depicts the stakeholders involved in the transaction and the interface with the regulatory laws/organizations.



4.2 In a strategic sale, the obvious stakeholders are the Government and the Strategic Partner. However, there are others also whom the transaction affects. They are the other shareholders and the employees. Depending on the success of the transaction the value of the shares held by the other shareholders would behave. Therefore, they are directly affected**.** Transfer of shares is generally governed by the provisions of the Companies Act, 1956 (sections 108 etc). In case of listed companies, however, the interest of the small investors is taken care of by SEBI through its various regulations.

What we are concerned with most are the regulations regarding takeovers, listing and de-listing. The SEBI Takeover Code gets triggered when a person acquires more than 15% of the voting equity shares of the company. Then, the person taking over these shares is required to make a public offer to purchase shares not less than 20% of the equity of the company. This provision has a great impact on the strategic sale transaction. For instance, in the example given above, the Strategic Partner would have to buy another 20% of the shares from the public which means he has to buy 45% of the shares i.e. the transaction size more than doubles, which in big PSUs may mean enormous sums of money. When the deal size goes up, it reduces the number of players and hence competition. The other impact it can have is that it reduces the floating stock, which can at times go even below 10%, resulting in de-listing of the company. Reduction in floating stock affects trading and hence impacts the value of the residual shareholding of the Government. Apart from the immediate effect the transaction would have on the share prices, the other shareholders also get affected depending upon whether the Strategic Partner enhances corporate value and hence their earnings or not.

5. The employees also are equally, if not more concerned. From the security of the public sector work environment they would find themselves in a new atmosphere of increased competition, demand for higher productivity and accountability. They would, therefore, logically try not to let go the protections presently enjoyed by them. Government, in a welfare state, also would like to look after the employees' interest. There obviously has to be a trade off, however, between the protection that the employees can be given and providing to the Strategic Partner a degree of freedom to run the company. These competing interests would have to be carefully balanced in drafting the Agreements.

6. The PSU is clearly one important player that gets affected by the transaction. Passed on to the hands of a serious Strategic Partner, its worth goes up. But the reverse could also happen.

7. The Strategic Partner, perhaps, has the highest stakes. In case the deal does not work out right he loses money and reputation in the market. In case his assessment of the potential of the company, its assets/liabilities position and his ability to implement a good business plan is right, he gains money, reputation and goodwill. The questions that confront him are: Will he get effective control of the company? What kind of representations and warranties should he give? What exit options should he have? What are the safeguards against breach by Government or in case of force majuere events? What restrictions can he live with regarding employees etc? The Government, on the other hand, is concerned with similar questions. The Government's chief concerns would be:

- Protection against asset shipping by the Strategic Partner.
- Protection to employees post-disinvestment.
- Exit options for the balance shares held by Government of India.
- A reasonable period for which the Strategic Partner may not exit the Company ('Lock-in' period). Typically, this is 3/5 years.

All these would govern the structure of the Agreements.

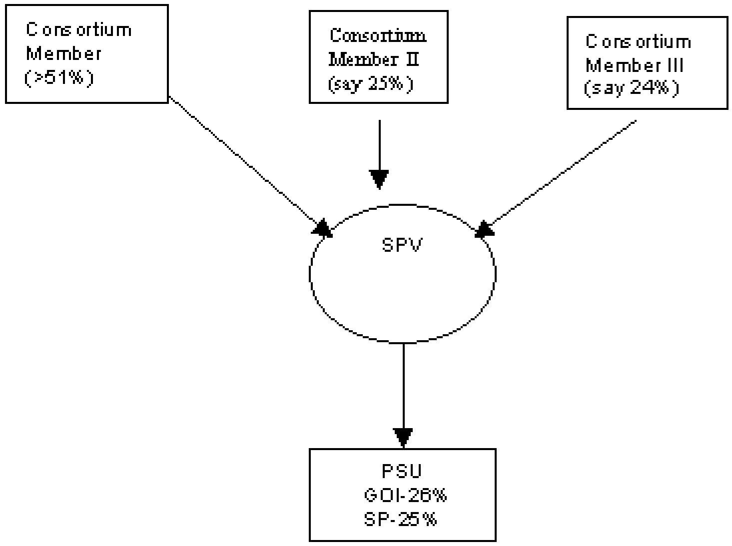
8. Typically, industries would have environmental issues, especially for manufacturing units. They may not be very relevant, however, in Consultancy Companies or Software Companies. Therefore, the Agreements have to, at times, address the environmental issues clearly e.g. which party takes what part of the risk in regard to responsibilities for actions taken/not taken prior to disinvestment.

Transaction Documents

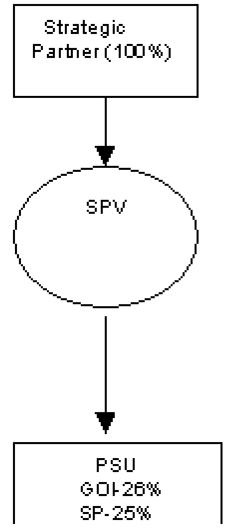
9. The concerns of the various stakeholders are taken care of through the transaction documents. These documents are:

- Share Holders Agreement (SHA)
- Share Purchase Agreement (SPA)
- Parent Guarantee Agreement (PGA)

Strategic sale transaction has two elements – (i) the transfer of shares and (ii) the transfer of management. While the SPA governs the transfer of shares part of the transaction, the SHA governs the transfer of management issues. Need for a PGA occurs whenever the Strategic Partner or the consortium, which is bidding, takes over the company through a Special Purpose Vehicle (SPV). The SPV is nothing but another company formed in which the Strategic Partner/consortium members have shareholdings (see diagram below). The PGA governs the do's and don'ts for the Strategic Partner vis-à-vis the SPV.



Consortium Bidding through SPV



Single bidder through SPV

The figures in parenthesis indicate the percentage shareholding of the Strategic Partner/Consortium Members in the SPV and the Shareholding of the SPV in the company. The consortium typically has a lead bidder who may be required to hold more than 51% in the SPV. We may now look at how the various concerns are taken care of in the transaction documents.

Share Holders Agreement

10. The shareholders agreement defines the relationship between the Strategic Partner and the Government (the shareholders) once the company is transferred to the Strategic Partner. Broadly, it has to address issues such as:

(i) When does the SHA come into force?

(ii) How does the Strategic Partner get management control? i.e. what will be SP's/Governments representation on the Board, who will appoint the Chairman, the Managing Director? What will be the quorum for the meetings? Will the Government have any affirmative rights in some matters e.g. disposal of assets, rightsizing the employees? What happens in case of a deadlock between the partners?

(iii) What would be the mechanism for raising capital?

(iv) What are the Representations and Warranties from the Strategic Partner, the Government and the Company?

(v) What are the duties and obligations?

(vi) What are the exit options of the parties to the Agreement? Are there lock-in periods?

(vii) What happens in case of disputes? What are the arbitration provisions?

(viii) What is the Term of the Agreement and how does it terminate?

(ix) What are the breach/default clauses and the penalties for breach/default?

The SHA is divided into different sections dealing with the different issues. We now take up some of the important sections.

Recital

11. To start with, the SHA has a recital section, which basically sets out the spirit of the agreement. This is not legally binding on the parties, as it is only a broad statement of intent.

Recital in the Share Holders Agreement would typically state, inter-alia, about assurance by the Strategic Partner:

- to continue with the existing employees with service conditions not inferior to what they currently enjoy and, in case of retrenchment, offer of at least VRS.
- to make best endeavor to protect the interest of scheduled caste/scheduled tribe/handicapped employees.
- against asset stripping.
- to continue the line of business following best business practices.

Representations and Warranties

12. In such Agreements, the Representations and Warranties (R&W) given by the parties i.e. the Strategic Partner, the Government and the Company become very significant. This is because it is based on the Government's/Company's R&W that the Strategic Partner makes an offer and if there is any error in the R&W by these parties, the Strategic Partner may get a completely wrong picture of the Company/Regulatory requirements etc. which would lead to severe disputes between the parties. Similarly, the R&W by the Strategic Partner indicates to the Government the competence or capability of the Strategic Partner to take over the company and run it to the satisfaction of Government. In a sense, the R&W's become the foundation of the deal itself. Therefore, these have to be carefully thought out and worded. The R&W's typically would comprise covenants like:

- that the parties are competent and have the authority to enter into the Agreement.
- that either party is not bound or is party to any lease, agreement, decree, judgment etc. under which default would occur in case the party executes this Agreement. In the case of Government this clause is qualified with the expression ‘to the knowledge of Government’.
- the Strategic Partner R&W will include that Strategic Partner would not retrench staff etc.
- both sides would vote in order to fulfill provisions of the Agreement.

The reader is reminded that this is in no way an exhaustive list but is only illustrative.

<u>Asset Stripping</u>

13. Perhaps the biggest concern on the part of Government in case of strategic sale of PSUs is that of asset stripping by the Strategic Partner. Most of the PSUs have valuable assets in the shape of plant and machinery, land, buildings etc. The Strategic Partner may very well dispose of these assets, make money on that and quit, leaving another sick industry behind. Though the Strategic Partner is chosen very carefully and one to ensure that the Strategic Partner is a serious party who is keen to run the company and help it grow, Government should always be careful to protect against any misuse of the assets by the Strategic Partner. Therefore, a clause on affirmative rights of Government in case of sale etc. of assets after takeover should exist. Presence of a Government nominee for quorum of meetings to consider asset sale etc. is a must, even for adjourned meetings. This right would typically terminate with the termination of the Agreement. It may not be desirable, however, to have a complete ban on asset disposal without Government vote, as it may be necessary for the Strategic Partner to replace some old assets with new ones or dispose of some non-core assets to generate cash in the normal course of business. What should this threshold be? It can be in the range of 10-26% of the net assets of the company for one or a series of transactions.

<u>Exit mechanism</u>

14.1 When a company is being taken over by a Strategic Partner, both the Strategic Partner and the Government would like to know upfront about the exit mechanisms. Normally, there is a lock-in period for the Strategic Partner before which he cannot sell whole/part of purchased shares –typically 3/5 years. This is because Government would not like to encourage a fly-by-night operator take over a crucial Government asset. Once the bidders know that Government wants a stable and serious minded partner in the business, only serious parties would come. Similarly, in case of the bidder coming through an SPV, it is important to stipulate a lock-in period (matching with the lock-in period for the company shares) for the holding of the Strategic Partner in the SPV. Otherwise the lock in period in case of the PSU shares becomes meaningless, as the bidder can exit out of the SPV and the Government may be left with an undesirable partner.

14.2 Once a party has decided to exit, the other party should have the right of first refusal. This can act against Government at times because, in future, when Government wants to disinvest further, no serious offers may come as those parties would be aware of the right of first refusal provision in favour of the Strategic Partner. Right of first refusal is normally reciprocal. Usually, the Agreement would also provide for tag-along rights to the parties in case they do not exercise their right of first refusal. Tag-along right means that in case the Strategic Partner is selling its shares to a third party, the Government can require (the tag-along right) that the government's shareholding be also sold along with the Strategic Partner's share at the same price.

14.3 For the Government, there could also be a lock-in period after which it can exit from the balance holding at any time. This may be desirable in some cases where the Strategic Partner may like to have Government as a partner for some time at least, during which period, using the Government's presence, some issues (licenses, land issues etc.) involving dealings with the Government can be resolved quickly. Government would then have a 'put' option exercisable after a certain period of time (say 1 year). The Strategic Partner may also look for a 'call' option to buy out the Government but this should typically get triggered after some period of time (3-5 years depending upon the PSU). The general idea is that the Strategic Partner is there to stay and, depending upon the situation, Government would exit. After sometime, the Strategic Partner should have the freedom to go it alone and buy out Government because, in any case, the policy is for Government to ultimately quit from the commercial venture. In case of the Strategic Partner using the 'call' option or the Government using the 'put' option, the Takeover code should normally not get triggered, as it is a transfer between promoters. However, the Takeover code stipulates that this exemption is available only if the shareholder has been holding not less than 5% shares in the Company for a period of at least three years prior to the proposed transfer. SEBI has now exempted the Strategic Partner from the requirement.

<u>Raising of Capital</u>

15.1 On takeover, the Strategic Partner would in all likelihood have to immediately inject funds into the company for capital expenditure or to meet pending revenue expenditure. This would be required in the case of sick PSUs and may even be required in profit making PSUs as well. Therefore, the Government may agree to the Strategic Partner bringing in funds at the time of takeover itself in which case provision in the Agreement has to be made for such ‘contribution’ shares. In other cases, the Strategic Partner may like to first take over the management and then look to raising capital. The Agreement has to clearly provide for such situations. Capital raised can be either as equity or as a loan. Equity capital can be raised in the following ways:

- Rights issue
- IPO
- Preferential Allotment

It may be noted that though IPO and Preferential Allotment require Special Resolutions (which means it requires Government’s affirmative vote in the general meeting, a Rights issue does not).

15.2 The question to be answered is, can the Strategic Partner raise capital – equity or loan - without any restrictions? Since Government would not be in any position to contribute to the capital requirements, any equity subscription would mean that the percentage holding of the Government would be going down. If the post transfer holding of Government were 26%, then this would imply that Government holding would go below 26% and Government would lose control as vested in the special resolution provisions of the Companies Act. Whether that is desirable? The one safeguard is that even if the Government holding goes below 26%, if the affirmative rights survive, Government’s interest vis-à-vis asset stripping, employee protection etc. remain as the Government can always block such a proposal being passed in the Board meeting/general meeting. But a situation may arise that within the first few months Governments share holding can go below the stipulated 15%/10% (See Termination section) limit beyond which the Agreement itself does not survive. Therefore, it may be necessary that there would be a period of moratorium (say 1 year) on proposals for raising capital through equity. Or, alternatively, the agreement may provide that for the lock-in period (3/5 years) even if agreement terminates Government will have affirmative vote on select items (say asset stripping, employees) as long as government has one share. The Board shall determine the pricing of such fresh equity. The Agreement should also state what are the restrictions for raising equity/loans from a third party through preferential allotments etc. or through renunciation of one’s rights issue. Normally renunciation can be to an affiliate. An affiliate means that entity which is either the holding company or subsidiary or owns or controls such party or is owned and controlled by such party or is owned or controlled by the same person who either directly or indirectly owns or controls such party. If renunciation is to other than an affiliate then the other party should have a right of first refusal.

<u>Board Representations & Quorum</u>

16.1 The control on management by the Strategic Partner will be through the Board. Therefore, this becomes very important. Usually, the representation on the Board is pro-rata with share holding percentage. In some cases Government may like to keep at least one Director with some affirmative rights though such a situation should normally not be envisaged. The affirmative rights should go with the termination of the Agreement except for situation explained in para 15.2. In fact, Government should not have a Board position if Government holding goes below a certain percentage –say, 10/15%. In some cases the Government may have the right to appoint the Chairman but the Strategic Partner should appoint the Managing Director. Otherwise, the Strategic Partner cannot have effective management control. Since the minutes of Board meetings are issued by the Chairman this post becomes crucial at times even though the Chairman is not given any casting vote. Another issue that arises is what happens to the existing Functional Directors who have been appointed by the Government for fixed tenures (3-5 years). The Agreement could ensure protection to them through provisions for compensation to them for their balance tenure etc. in case the Strategic Partner does not retain them in the company. The Agreement could also provide that these persons be also provided VRS applicable for the below Board level post which they had been earlier holding.

16.2 Procedure for meetings of the Board may also be stipulated, though in the absence of it, the normal provisions of the Company Act would, in any case, apply. But the purpose of this clause is to specifically keep a clause that at each meeting of the Board the Company will report on the current status of the company and major events so that the Government nominee is informed of the goings on in the company after takeover. The quorum clause also should state that there would be no quorum unless at least one Government nominee Director is present in case any matter relating to the items on which Government has affirmative rights is being taken up. Even for adjourned meetings this should be insisted upon. Similarly, in case of a general meeting also it should be provided that the quorum for meetings on matters requiring Special Resolution or included in the list of issues requiring Government's affirmative rights would not be complete unless at least one Government nominee Director is present. Here also, this condition should be applicable for adjourned meetings of the general meeting.

Indemnification & Confidentiality

17.1 Through this clause, either party indemnifies the other for any losses, liability, claim, damages etc. which arise out of breach by that party or any of its R&W, covenants, or agreement provided, however, that this indemnity shall not cover any special, indirect, incidental or consequential damages.

17.2 The Strategic Partner also agrees to keep confidential all information about the company regarding customers, products, technology, trade secrets, systems, operations, or other confidential information. The period could be specified (say three years). These could be reciprocal provisions for Government.

Breach and its consequences

18.1 Breach takes place when either party breaches any of the R&Ws or other covenants in the Agreement. Force Majuere clauses normally would be added for making exceptions to attracting the breach clause. In case of a breach it is common practice to add a cure period (30 to 90 days). The cure period is of particular importance to Government as procedures in Government are bound to take more time. In some formulations one may also include as default by the Strategic Partner the event of the Strategic Partner getting hit by any of several events like bankruptcy, convictions, etc.

18.2. In case of breach/default, the non-defaulting party will have a 'call' option for major breaches at say 50% of Fair Market Value (FMV) or purchase price, whichever is lower and 75% for minor breaches. Major breaches could be asset stripping, employee related etc. In case of breach, the non-defaulting party typically also will have a 'put' option apart from the 'call' option. For major breaches at say 150% of FMV or purchase price, whichever is higher and 125% for minor breaches.

Affirmative rights

19. As explained earlier, the Government cannot hand over the reigns of the company to the Strategic Partner and then take no interest in the running of the company. It has to ensure that the Strategic Partner is following the Agreement both in letter and spirit. It has to make sure that the assets of the company are not being misused or quietly disposed off or that the employees are not being adversely treated or that the Strategic Partner is not taking any action detrimental to the interest of the company. How does the Government ensure that? One way is as suggested on the section on Board Representation i.e. through its nominees getting the progress report from the company in each Board meeting. However, this is not sufficient as the Strategic Partner, through the majority in the Board, would be able to get any motion passed. The way to stop this is for the Agreement to provide for veto rights to the Government in certain important matters. These are called Affirmative Rights of Government. They are included to ensure that the Strategic Partner fulfills the desired intention of the strategic sale by the Government and utilizes the assets in enhancing the value of the existing business and ensure growth and not misutilise or harm the assets, including the employees. The items on which affirmative vote of the Government nominee on the board would be required, inter-alia, cover:

- Asset stripping i.e. restriction on the Strategic Partner to sell or otherwise dispose of assets of the company beyond a certain limit - say 25% of the fixed assets etc.

- Line of business cannot be changed

- Guarantee exposures beyond a certain limit cannot be taken

- Change in service condition of employees or decision for retrenchment

- Opening new line of business

- Winding up of the company

- Reduction of share capital / share buy-back

The items included above are only illustrative and by no means exhaustive. It would depend from case to case on what items Government would like to reserve this right. It should not be so restrictive as to frustrate the efforts of the Strategic Partner or be so liberal as to give an absolute license to the Strategic Partner to do whatever he likes. It should be noted that the list of items included for Affirmative Rights might include items, which do not require a special resolution under Company Law. Secondly, it can be provided that Affirmative Rights of Government survive even when Government holding goes down below 26%. As explained earlier, there are some issues on which a Special Resolution is required and Government holding of 26% stake can block a proposal in the general meeting. Therefore, an item which is not included in the list of items requiring Affirmative vote of Government but is an item requiring a Special Resolution would be passed in the Board if Strategic Partner has majority but then Government can block it in the general meeting. No provision of 'deemed consent' by the Government should be provided if the Government representative halts the matter from proceeding by remaining at the meeting.

Deadlock

20. Dead-lock occurs when Government holds back consent in a Board meeting on any affirmative right issue. Deadlock is first tried to be resolved through mutual discussion of senior representatives of parties. If discussion fails, then Government could have a 'put' option at higher of FMV or unit sale price (at the time of deadlock the Strategic Partner can hold more than the shares transferred at the time of strategic sale) plus interest minus dividend paid. The logic behind providing this option is that in case of minor issues, if Government thinks fit, the Government can let the Strategic

Partner run the Company by quitting through the 'put' option at a premium as a dead-lock would mean that the partners are not able to carry on together and their continuing would harm the Company. If it is major issues say asset stripping, then Government would not utilize this 'put' option and the Strategic Partner would have to live with the situation.

Termination

21. Termination would typically take place –

- by mutual agreement
- company becoming bankrupt
- either party owns less than x %(e.g. 10%/15%/25%) of the outstanding and issued voting equity share. and/or either party owns more than x %(75% is relevant usually) of voting shares

In some extremely sensitive cases Government can insist that the Agreement does not terminate till Government holds even one share. It should be understood that the Representations and Warranties also would automatically terminate with termination of the SHA. But there may be some covenants that have to survive termination e.g. covenants on confidentiality, indemnity. In case Government wants protection to the employees not to terminate with the Agreement then this should be taken care of also and this included amongst items that would survive termination. Similarly, it should be noted that the affirmative rights of the Government would also seize once the Agreement terminates. It should be noted that even if the Agreement terminates, the parties are not released of the liabilities accrued prior to the termination.

Arbitration

22. Arbitration clauses to take care of disputes concerning interpretation of the agreement or application or rights and obligations should be provided in the Agreement. Indian Arbitration and Conciliation Act, 1996, should govern arbitration.

Applicable Laws

23. Indian laws would be applicable.

Other conditionalities

24.1 Once the company is handed over to the Strategic Partner, Government has to take care that the Strategic Partner would not in any way enter into any venture or activity that creates competition for the taken over company – this could be a 'good faith' clause.

24.2 FMV determination procedure should be clearly laid out in the Agreement. Either some specific names of reputed valuation firms can be mentioned in the Agreement or procedure for selection of the Firm/Firms should be stipulated. The other alternative in case of listed companies is to use the term Market Value (MV) as defined in the SEBI Takeover code of a six monthly average.

Share Purchase Agreement

25.1 As explained earlier, the SPA covers the transaction of purchase of shares by the Strategic Partner. After the purchase of shares by the Strategic Partner through this Agreement the provisions of the Share Holders Agreement govern the relationship between the Strategic Partner and the Government. The SPA envisages the following stages:

- The SPA is signed.
- The SPA closes when the Strategic Partner purchases the shares and Government receives payment.
- Closing can take place only when all Conditions Precedent i.e. all approvals, all R&Ws, all obligations, covenants and agreements etc. are performed.
- The date on which closing takes place i.e. the Strategic Partner purchases the shares relying on R&Ws and covenants of government and government sells the shares is called the Closing Date.
- The Closing Date could be the day on which SPA is executed or any other date agreed to by the parties.

To clarify, the sequence of events is that the SPA and SHA are signed, the SPA Conditions Precedent gets fulfilled and then closing occurs on the Closing Date. The Closing Date is mentioned as the effective date in the SHA when the SHA comes into effect i.e. the only Condition Precedent for SHA to be effective is for closing to take place under SPA. The SPA is linked to the SHA through the recital clause of the SHA which states that the Strategic Partner and the Government are parties to the SPA and also through the effective date clause in the SHA stating that the SHA will come into force from the closing date (which date is defined in the SPA). The SPA recital also states that the parties are in agreement through the SHA as to the manner in which the affairs of the company would be carried on after the Strategic Partner acquires the purchased shares.

25.2 The SPA clearly states the number of shares being transferred by the Government to the Strategic Partner, the price per share at which the transfer will take place and the total consideration.

25.3 The closing of the agreement could be in one of two ways. Either the full purchase price is realized at one go when purchase price is received and SPA/SHA is signed at the same time or it could be a two-part exercise i.e. get a certain amount (say 50% of purchase price or just an Earnest Money Deposit) on signing of SPA and then, when all condition precedent are fulfilled by getting all necessary approvals, SHA is signed and balance payment made and management handed over. As explained earlier, in case of a listed Company, there exists a further issue of Public offer. In case of a listed Company, management transfer cannot take place until the Public offers announcement is complete, which has to be made within 4 days of signing of SPA. In the case of listed Companies, therefore, the SPA is first singed, the Strategic Partner then makes the open offer announcement and anytime after 4 days the SHA is signed, with payment of transfer price and change in management control.

Post Closing Adjustments

26.1 During the data room visits and the due diligence exercise by the Strategic Partner, the Strategic Partner gets the picture of the assets and liabilities of the company as on a certain date, say 31.3.2000. The deal may actually close at a much later date, say 10.10.2000. In this intervening period, the company has been functioning and the asset/liability position has undergone a change. There are two ways of handling this. One is to not make any provision in the SPA for this. The Strategic Partner makes a judgment and takes account of this when he bids for the company. Normally, however, the Strategic Partner would insist on such a provision especially in a company whose performance is in the decline. On the other hand, it is in Government's interest not to have a 'Post-Closing' adjustment in such cases as Government would have to pay back money and get criticized. For example, Government may receive Rs. 150 crores as bid price today as against a reserve price of say, Rs. 100 crores. 'Post-Closure' may result in Government having to pay say; Rs. 80 crores back to the Strategic Partner. So, effectively Government sells at Rs. 70 crores, Rs. 30 crores below reserve price- sufficient fodder for the Press and the opposition! These are called Post Closing Adjustments. One way to do this is to work out the Net Working Capital (NWC) and Debt Amounts (DA) for the last balance sheet (31.3.2000 in our example) and the closing date accounts (10.10.2000 in our example). If the NWC increases the Strategic Partner pays the Government and vice versa. In case the DA increases the Government pays to the Strategic Partner and vice versa. This is the arrangement in the Modern Food SPA. There is, however, one drawback in this method, which is that if the company takes a loan in the adjustment period and converts it into a fixed asset then the Government pays the difference in the Debt Amount to the Strategic Partner and the company gets to retain the asset so created. This is loaded against the Government. Therefore, the better formulation is to work out the Net Asset Amount defined as the sum of the current and fixed asset minus the sum of all outside liabilities i.e. the networth (NW) of the company. If the NW increases, the Strategic Partner pays to the Government and amount in proportion to the shareholding sold by the Government and vice versa. For example, if the Government has sold 51% to the Strategic Partner and the NW has increased by Rs. 100 crores than the Strategic Partner would pay to Government 0.51 *100 = Rs. 51 crores. This is because Government as 49% holder in the Company will get the benefit of 49% out of the Rs. 100 crore increase as a shareholder. This adjustment is a one-time adjustment. The movements in the assets /liabilities position is determined through a post closing audit of the accounts of the company. Of course the principles adopted for this audit has to be the same as the one adopted closing adjustments would be closer to reality.

26.2 An interesting issue here arises in the case of a Listed Company. This is best illustrated through an example. Say the purchase price is Rs.500 per share at closing. The public offers under the Take over Code is say made at Rs.500 per share. If the post closing adjustment means Government pays to Strategic Partner Rs.200 per share then effectively the selling price is Rs.300 per share. In such a situation, since the public offer is Rs.500 and the takeover price is at Rs.300, the Strategic Partner would be typically expected under the Agreement to pay the Government the difference i.e. Rs.200 per share. This means the Strategic Partner gains nothing through the post closing adjustment and the Strategic Partner lands up paying a higher price to the public/Government. On the contrary if the post closing adjustment results in Strategic Partner having to pay Rs.200 per share to Government, then the effective transfer price becomes Rs.700 per share and the Strategic Partner would have to compensate the public @ Rs.200 per share. To avoid such complications 'Post-closing' adjustment clauses are not being incorporated in the current agreements for listed companies.

Representation and Warranties and Covenants

27.1 The covenants of the Government could be that the Government would not encourage any offer or proposal from another person to acquire the share; would allow a nominee of the Strategic Partner to be stationed at the company to oversee operation without interference in the conduct of the company affairs; without the Strategic Partner nominee's consent would not create a lien on the assets of the company, issue any shares, make any change in the company's memorandum of association or articles of association, declare any dividend, sell any asset, borrow any money, commit any further capital, run and preserve the business etc. i.e.

the Government would not take any major decision till such time the company is actually not handed over to the Strategic Partner.

27.2 The representation and warranties of the Government could basically be that the transaction has been duly authorized, that the execution of this agreement will not cause any breach of other judgments or decree or any agreement etc. by which the Government is bound and that the Government has made available all relevant information which would be material to the purchaser.

27.3 The company's representation and warranties also could include that it has the necessary authorization to carry out its obligations under the agreement, that there are no material information on damage, destruction, loss etc. that has not been disclosed; that there are no litigations which would materially and adversely affect the transfer of the purchase shares or the future of this company; that beyond what has been disclosed there are no action suits, proceedings, investigation, etc. pending and that tax returns have been filed; that the company is in compliance with relevant laws relating to employees, environment, safety etc. and that the company is not a party to the agreement which will materially and adversely affect the operation of the company after transfer.

27.4 The purchaser, apart from the representation that it has the necessary authorization to enter into the agreement, also in its representation and warranty provides that it is not a party to any agreement, obligation etc. which would get contravened or breached or under which any default would occur or an encumbrance would be created as a result of execution of the SPA. It also warrants that there is no suit, action, litigation, investigation, claim, complaint or proceeding etc. in progress or pending or threatened against the SPA so as to prevent him from fulfilling the obligations under the SPA or his ability to pay the whole or part of the purchase price.

27.5 The R&Ws survive for a specified period (R&W claim period), say 3 years.

Purchaser and Government Losses

28.1 There is another adjustment that takes place to the purchase amount, which is that arising out of losses incurred by either party due to breach by the other party of any of the R&Ws or the covenants, agreements or obligations in the SPA. However, the indemnity by Government in such cases is capped. In practice this cap is a fraction (Modern Food & Balco it was 70%) of the purchase price. The indemnity by the Strategic Partner is unlimited.

28.2 Claims under purchaser losses can arise through third party claims or non-third party claims. In case of breach by any party of representation or warranty, claim would have to be made within the R&W claim period and in case it arises out of breach of any covenant, agreement or obligation (in the Strategic Partner) then the notice has to come normally within 30 days of the breach. Why this distinction? This is because the R&Ws are more basic to the transaction unlike covenants etc. For instance, the Company makes representations regarding litigation cases pending. If there is a breach (i.e. wrong representation by Company) the litigation claim may take a long time to arise. Hence this R&W period is longer (around 3 years). In case of third party claim, the indemnifying party has the right at its option and expense to participate in the defense of the third party claim but not to control the defense, negotiation or settlement. The indemnifying party has the right to control the defense etc. when such claim involve only money damages or the indemnifying party has counter claims to such third party claim which the indemnifying party is not entitled to assert. The breach usually will have a cure period (30-90 days).

Other Adjustments to Purchase Price

29.1 There could be other adjustments to the purchase price. For instance, in the Modern Food (MF) document, four adjustment heads were identified:

Undisclosed assets: i.e. in case the company recovers any amounts in excess of a stipulated amount (Rs. One lakh in MF document) in respect of any claim or counter-claim not accounted for in the closing date statement (A).

Tax liability: i.e. any amount of tax (income tax, sales tax, excise duty etc.), which is disputed by the company on the closing date but had to be paid by the company after take over by Strategic Partner under protest (B). In case the tax authorities refund any money (C) or additional payments have to be made by the company (D).

Litigation: The government takes over the litigation liability for cases pending on the closing date (for a period of five years/ in case of MF) any payment under this head (E).

Certain amounts receivable: Of some identified 'Accounts Receivables' those portions which were deemed uncollectable by the post-closing audit, but later collected (F) and those which were deemed collectable and not collected (G).

The amount B was to be paid by the government to the Strategic Partner in a lump sum. For the rest, every six months a statement is prepared and Z = A + C + F – D – E – G was worked out. If Z worked out to be positive, Government gets paid. If Z is negative, then the Government pays the Strategic Partner.

29.2 The BALCO agreement has done away with this arrangement. As indicated earlier, in that case, all these factors get subsumed in the bid amount. The point to be noted here is that though such adjustment clauses captures the assets/liabilities transfer more accurately, once the company is handed over to the Strategic Partner, such survival adjustments in perpetuity would be very difficult to monitor and, therefore, may not be very practical and may, in fact, result in loss to the Government.

Termination:

30.1 The Termination of the SPA means that the deal is off because SPA's termination means the purchase price has not been paid. That Government may or may not forfeit the bid amount or any other part deposits is another matter. The SPA terminates in the following situation:

(a) by written consent of each of the Government and the Purchaser

(b) by the Government in the event that the Purchaser fails to fulfill any of its Conditions Precedent or fails to fulfill any of its obligations at Closing;

(c) by the Purchaser in the event that the Government fails to fulfill any of its Conditions Precedent or fails to fulfill any of its obligations at Closing.

30.2 Normally, confidentiality clause will survive for a fixed term (say 3 years). However, all representations and warranties usually have a fixed survival period, typically three years. This means that if the agreement terminates, say after a month, the deal is off but the purchaser and government losses will survive beyond that up to a period of three years.

Parent Guarantee Agreement

31. Through the guarantee agreement each of the persons who form the SPV (called 'Principals') basically give a guarantee that each principal jointly and severally, irrevocably and unconditionally guarantees to the Government that the SPV shall, at all times, fully and faithfully perform and discharge all its obligations under the Transaction Agreements (SPA/SHA) and that the SPV shall, at all times, duly comply with all the terms and conditions of the Transaction Agreements; and indemnifies the Government against losses liabilities etc. of breach by the SPV or any of the principal of any R&W etc. in the SPA/SHA/PGA. Rest is legalese.

Miscellaneous

32. Though we have discussed the SHA and SPA as two separate documents it is also possible to merge the two documents and sign one single document in case the whole transaction is being closed in one shot i.e. all approvals are in place and the purchase price is paid and the Agreement signed simultaneously. However, in case there would be a time lag on getting approvals, so that the bidder may not back out and frustrate the process, SPA could be signed and on then receiving the approvals the SHA too is signed. In case of 100% sale of Government equity, of course, there would only be a SPA as Government would no longer be a shareholder. However, warranties by the Strategic Partner on protection to employees etc can still be built into the SPA and enforced. The Agreement would also stipulate that breach on such warranties could attract penalty such as Government requiring the Strategic Partner to sell back the purchased shares to Government at a discount.

[Note: This paper is based on the experience gained so far in the Ministry of Disinvestment. It only attempts to provide a flavor of the strategic sale transaction documents. In actual practice, these are documents drafted in detail and in legal language. Moreover, there is a constant flux of ideas requiring changes in the structure of these Agreements from one case to the next. Therefore, there are going to be many modifications as we proceed along the way with the various disinvestment transactions through strategic sale.]

Annexure –I

EVENTS REQUIRING SPECIAL RESOLUTION

1. To alter the provisions of the memorandum, to change the objects of the company, and to change the place of the company registered office from one State to another.

2. To commence any new line of business {Section 149(2A)}

3. To change the name of the company (also requires approval of the Central Government) {Section 21}.

4. To omit the word “Limited” or “Private Limited” from the name of the company {Section 21}.

5. Change of name of charitable or other non-profit company by omitting the word or words "Limited" or "Private Limited". {Section 25(3)}.

6. To alter or add to the articles {Section 31}.

7. To purchase the Company's own shares or specified securities {Section 77(2)}

8. To issue sweat equity shares {Section 79A}.

9. To issue further shares without pre-emptive rights {Section 81(1)} to non-members {Section 81(1-A)} or to convert loans or debentures into shares {Section 81(3)}.

10. To determine that any portion of the share capital not already called up shall not be called up except in the event of, and for the purpose of, winding up the company {Section 99}

11. To reduce the share capital (this requires authorization by the articles and confirmation by the Court) {Section 100}.

12. Approval of variation of rights of special classes of shares {Section 106}.

13. To remove the registered office of the company outside the local limits of the State, Town, or Village in which it is situated {Section 146}.

14. To keep registers and returns at any other place than within city, town or village in which the registered office is situated {Section 163}.

15. To authorize the payment of interest on the paid-up amount of share capital raised for the purpose of defraying the expenses of construction of any work or building or the provisions of any plant that cannot be made profitable for a lengthy period {Section 208(2)}.

16. To request the Government to investigate the affairs of the company and to appoint inspectors for the purpose {Section 237}.

17. To fix remuneration of directors, where the articles requires such resolution {Section 309(1)}.

18. To sanction remuneration to directors other than managing or whole-time directors on percentage of profit basis in certain instances (Section 309(4)} and renewal under sub-section (7)}.

19. To consent to a director or his relative or partner or firm or private company holding an office or place of profit, except that of managing director, manager, banker, or trustee for debenture-holders of the company {Section 314}.

20. To make the liability of any director or manager unlimited where so authorized by the articles {Section 323}.

21. To appoint auditors in the case of a company in which the Central and/or any State Government, and/or public financial institution or institutions together hold twenty-five per cent or more of its subscribed capital {Section 224A}.

22. To appoint sole selling or buying or purchasing agent in the case of companies having paid-up share capital of rupees fifty lakhs or more {Section 294-AA}.

23. To make inter-corporate loans and investments or guarantee/security to be given, etc., if the aggregate amount thereof, exceeds the limit of 60 percent of company's paid up share capital and free reserves of 100 per cent of its free reserves, whichever is more {Section 372A).

24. To apply to a Court to wind-up the company {Section 433(a)}.

25. To wind-up the company voluntarily {Section 484(1)(b)}.

26. To bind the company by arrangement made under Section 517.

27. For various other matters pertaining to the winding up of the company. {Sections 433(a), 494(1)(b), 507, 512(1), 546(1)(b), 550(1)(b)}.

28. To alter the constitution of a company registered under Part IX {Section 579(1)}.