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DOWN ROUNDS AND M&As AMIDST COVID-19 AND THEREAFTER

Spotlight on Anti-Dilution, Liquidation Preference, and Drag Along Provisions



BACKGROUND

The Impact of COVID-19 is particularly severe on new age and emerging businesses. Many such businesses will require bridge or further equity financing rounds, some of which are expected to be 'down rounds'. Many others will either consider M&A opportunities themselves or may undergo forced M&As driven by investors.

Anti-dilution, liquidation preference (LP), and drag provisions will come under scrutiny and analysis over the next few months.

Companies and investors (particularly foreign investors) may do well to keep the following key provisions in mind existing shareholders' agreements (SHAs) as well as negotiating them in new SHAs.

For a basic refresher on the broad concepts involved, please refer to the supplementary document [here](#).

ANTI-DILUTION

Giving effect to investor anti-dilution rights

- Usually through a pre-built conversion price / ratio / formula in case of convertible instruments, with following considerations:
 - Conversion price / ratio / formula to be determined upfront.
 - Price at the time of conversion to be not less than the fair market value (FMV) at the time of issuance in case of non-resident investors.
 - Change in conversion ratio (for non-resident investors) after issue of convertible instrument may require prior approval of the Reserve Bank of India.
 - Tax implications of a post-issue change in conversion ratio to be assessed.
- Where the investor holds equity shares, additional equity shares would need to be issued by the company or acquired by the investor from other shareholders / founders, with following considerations:

- To be done by way of a: (a) bonus issue; (b) rights issue; or (c) preferential allotment.
- To undertake bonus and rights issue, specific considerations under the Companies Act 2013, exchange control regulations, as well as tax laws to be taken into account.
- Preferential allotment requires detailed compliance under the Companies Act 2013 including procurement of a valuation report.
- Secondary sales at less than FMV to have tax implications and in case of non-resident investors, to adhere to pricing guidelines.

Founders' protection in a dilution event

- Typically, founders would not be entitled to anti-dilution protection under the SHA.
- In some cases, investors and other shareholders may agree to provide anti-dilution protection to the founders which will need further analysis.
- Since founders generally hold only equity shares, the considerations for effecting anti-dilution by further issuance of equity shares will apply.
- Founders can also be issued / provided with other forms of securities or benefits to overcome such issues (for instance, stock options in case of registered start-ups or rights issue in other cases). Tax considerations in both cases to be borne in mind.
- Given the current scenario, it may not be unusual to see investors waiving their anti-dilution rights for a down round to preserve the company's capital base.

LIQUIDATION PREFERENCE

Review existing SHAs to understand the scope including the items below

- 'Liquidation event'. Understand the triggers for 'liquidation events'. Typically, mergers, change of control transactions, sale of substantial assets, winding-up, etc., are included as 'liquidation events'.
- Priority of payments and inadequacy of funds. Language around waterfalls and the manner in which funds will be distributed needs to be examined particularly in the event of financial distress. One needs to be clear on the nature of the preference – whether it is participating or non-participating. One also needs to check if there are any anomalies in the language – for example, if senior payments are limited only to pre-determined returns on the investment amount or if pro-rated shares of the surplus are also guaranteed as senior payments.
- Preference clauses. In case of winding-up, the priority of repayment is statutorily prescribed such that shareholders may be repaid only after all outstanding liabilities have been discharged. Liquidation preference clauses that deviate from statutory waterfalls need to be analysed. In some cases, personal liability provisions on the promoters are incorporated that force the promoters to make good the shortfall to the investors separately.

Price considerations

- Floor price. If shares are being sold by resident to non-resident acquirers, the price of such shares cannot be lesser than the FMV.
- Ceiling. If shares are being sold by non-resident investors to resident acquirers, the price of such shares cannot be higher than the FMV.
- Tax concerns. Different values for shares held by founders and investors may give rise to adverse tax implications under the Income Tax Act 1961.

Other key considerations

- Examination of LP provisions under the Insolvency and Bankruptcy Code 2016 has also not been substantially tested and in such a case, the provisions of the code will trump the SHA to the extent there is a conflict.
- Given the expected prevalence of down rounds and distressed funding, investors are likely to negotiate a higher liquidation preference (*i.e.*, >1x) as well as an increase in participating preference constructs. Again, for non-resident investors, the implication of this as an instrument of an assured return must be evaluated.
- Foreign investors are not allowed to derive assured returns from foreign direct investments – LP clauses may be tested on this ground depending upon its drafting.
- Mergers / demergers need to satisfy specific conditions to become tax neutral which may require deviation from the LP clause.
- Distribution of proceeds in case of an LP triggered by asset sale needs to be examined in terms of the language of the SHA.

DRAG ALONG

Review existing SHAs to understand the scope including the items below

- When can this be exercised? Does the SHA allow for only a post exit period drag or does an accelerated drag provision exist? Are accelerated drag along rights exercisable if the performance of the company falls below agreed levels?
- Who can trigger the drag? Are there any other provisions in the SHA that imply any additional consents to be obtained for exercise of drag? Do any other contracts of the company (for example, financing contracts) restrict the ability to drag?
- What is the extent of the drag? Can the dragging shareholder drag any or only all the remaining shares / shareholders? How does the drag get implemented if the dragged shareholders refuse to co-operate?
- Is there any price guarantee? Can the drag be exercised at the same price and on the same terms or is there a guaranteed price for drag exercise? How does one go about identifying which terms need to be similar – particularly in the context of LP stack.

Other key considerations

- In case the drag sale results in differential pricing of the sale, the same considerations as discussed in the LP section above to apply.
- A buyer in a drag sale, particularly a distressed sale, may want extensive representations, warranties, and indemnities in relation to the business. In many SHAs, this liability typically falls on the founders / dragging shareholder. All potential issues (including enforcement) of the above to be evaluated before enforcing a drag.
- Drag along rights have rarely been litigated in India and it is, therefore, uncertain if courts would look at these rights as inherently one-sided or unfair to a certain class of shareholders.

FURTHER INFORMATION

For any feedback or queries please contact our New Age and Emerging Businesses Practice Group at newage@khaitanco.com.

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