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Navigating Secondary Exits: Key Legal And Regulatory Considerations For Financial Sponsors

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The Initial Public Offering (IPO) market has remained volatile recently and given the global uncertainties, it is no surprise that the fluctuations in primary markets have spurred financial sponsors to look into alternatives to optimize their investments. Owing to this, the preference for secondary sale has grown and financial sponsors are eyeing this route for securing a timely exit. This article sets out a few key points that financial sponsors must bear in mind while evaluating exits from their Indian portfolio companies by way of secondary exits, a few challenges that they are likely to encounter and some strategies for mitigating risks.

1. **Coverage for operational warranties:** It is typical for buyers to insist on, and the sponsor seller should also be open to offer, warranties and indemnities to cover for: (i) title to its securities; (ii) its authority to enter into and consummate the transaction; and (iii) if applicable, its eligibility to a nil / lower withholding tax rate. Sponsors are reluctant to offer any operational warranties / indemnities relating to the portfolio company (unless the sponsor plays an active role in the target's day-to-day operations) and may insist that these are sought from the target's management. However, for such business warranties / indemnities, the buyer may not be comfortable with limiting its recourse against the target's management since the buyer would be conscious to preserve its relationship with the management and may have concerns regarding the management's (being individuals) financial capacity to honour any such indemnification claims. To bridge this gap between the contractual protection offered and the one desired by the buyer, the parties may consider exploring alternatives such as obtaining warranties and indemnities insurance (discussed below).

2. **Exchange Control Restrictions:** Indian exchange control regulations govern M&A transactions, including laying down norms for pricing, entry routes and sectoral caps. Typically, these restrictions do not apply or are less stringent when the buyer and the seller hold the same residency status under Indian exchange control regulations (i.e., either both are residents, or both are non-residents) and as such, offer more flexibility on structuring the transaction. For instance, (i) pricing regulations do not apply to a transfer of shares between two non-residents or between two residents; and (ii) restrictions relating to escrow and deferred consideration may not apply when the seller and the buyer hold the same residency status.

3. **Seller's Due Diligence:** Usually, financial sponsors are not actively involved in the day-to-day operations of the portfolio company and accordingly, may not be aware of any issues that the buyer may discover during its due diligence. To this end, the buyer could use downside surprises that it discovers, as a bargaining chip, to negotiate favourable terms for itself or even revisit the transaction valuation. As such, it has become increasingly common for financial sponsor to conduct its due diligence prior to the commencement of the sale process to identify any potential concerns and if resolvable, remedy them before kicking off the sale (or formulate negotiate strategies to deal with them). Any such pre-sale audit also helps accelerate the deal timelines since the portfolio company's management is likely to respond quicker to the diligence requests of the buyer and also assist the seller in putting together the disclosure letter.

4. **Indemnification claims beyond seller's life:** A financial sponsor may route its investments through a special purpose vehicle (SPV). In such cases, after the sale, the seller would either have wound itself up before the expiry of the indemnity claim periods or would have become a shell company with no significant operations after closing. As such, the buyer may have concerns about the ability of the seller to honour its post-closing obligations, and more importantly, its indemnification obligations. To mitigate this risk, the buyer is likely to insist on one or a combination of the following: (i) retaining a portion of the purchase price by depositing it with an escrow agent to honour any post-closing indemnification claims; (ii) the seller procuring a comfort letter / guarantee from an 'entity of substance' (usually the seller's parent entity or a general partner of the seller); and/or (iii) parties procuring a warranties and indemnities (W&I) insurance policy. Sponsor sellers, especially those that are nearing the end of their fund life, are under pressure to sell their stake in portfolio companies and quickly distribute the proceeds of their sale to their investors, and as such, they are usually not amenable to signing up to any holdback or escrow arrangements. Instead, as a compromise, they are typically willing to offer a parent guarantee / comfort letter or procure a W&I insurance policy to cover any claims that may come up after seller's fund life.
5. **Capped Indemnities**: As mentioned above, sponsor sellers are keen to achieve a clean exit from its portfolio companies and distribute the sale proceeds to their investors as swiftly as possible, while minimizing the risk of potential claw-backs of the purchase price. Accordingly, sponsor sellers usually push for the following: (i) all indemnification matters (including warranties relating to fundamental matters such as title to shares and their capacity to enter into the transaction) to have a finite claim period; (ii) exposure to all indemnification matters, including warranties relating to the aforesaid fundamental matters and specific indemnities identified pursuant to buyer's due diligence, to be capped at a certain percentage of the purchase price; and (iii) the entire consideration to be paid upfront at closing.
6. **W&I Insurance:** In India, W&I insurance is emerging as one of the preferred options to cover the buyer against any loss arising from a breach of a warranty or other subject matters of indemnification. In competitive auctions, either the bidders are increasingly taking out W&I insurance policies to make their bid stand out and lucrative for the seller, or the sellers are requiring that the bidder's bid on the condition that they will procure a W&I insurance policy prior to the closing of the transaction. A wellstitched W&I insurance policy helps shift some of the transaction risk from the seller and/or buyer to the insurer, and to that extent is a win-win for both. However, W&I insurances do not cover every risk and as such, provide for a host of exclusions (such as disclosed matters, forward-looking statements, and matters that are subject to purchase price adjustments). Recently, there has also been an increase in the adoption of a 'non-recourse' W&I insurance where the seller assumes no indemnification obligations for breaches of warranties other than for fraud.
7. **Restrictive Covenants:** Given that sponsors are in the business of investing in multiple companies operating in the same sector, they are unlikely to sign up for any non-compete covenants. Buyers are also usually open to considering the sponsor seller's request and would typically insist that the seller sign up to a robust confidentiality covenant requiring it to preserve the confidentiality of the information of the portfolio company that it may have acquired during its investment. However, in some cases, sponsor sellers should be open to signing up for non-solicit covenants restricting them from soliciting the employees and customers / clients of its erstwhile portfolio companies.
8. **Due Diligence and Confidentiality**: Like any other sale transaction, any sale process runs the risk of leakage of confidential information to competitors who may place their bids with the intent of gaining access to the portfolio company's confidential information, value, and strategy. In such a case, the sellers may consider reserving sharing the confidential information only to later stages of the due diligence

process. To protect against this risk, (i) the seller / portfolio company should enter into water-tight non-disclosure agreements protecting themselves against any misuse of any confidential information passed to the bidder prior to the consummation of the sale; and (ii) structure the due diligence into two phases – phase 1 would entail sharing of non-sensitive information to all initial bidders, and phase 2 would entail sharing of confidential information to all shortlisted / 'serious' bidders, once the seller has been able to ascertain the competitor's seriousness with respect to the deal.

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