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Ratchet mechanism under Thai law and its operation in acquisition transactions

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A "ratchet" mechanism may have a different meaning or purpose, depending on the context. For example, the ratchet may be designed to operate as an anti-dilution provision to protect existing shareholders from dilution by fund raising. Alternatively, it may operate as an incentive for management by increasing the amount of equity to the management if certain performance targets are reached.

This article focuses on how the ratchet operates as an incentive in an acquisition transaction to reward the management (e.g. original shareholders of the target company) whose proportion of ownership may alter as a consequence of the performance of the business at a certain time as set out in the forecasts, projections and investor's target. In this regard, the ratchet will have the effect of increasing or decreasing the management's shareholding depending on the performance of the business. The design of the ratchet varies from investment to investment.

Under Thai law, there is no specific provision providing for the nature or implementation of equity performance ratchet mechanism. Therefore, relevant parties in the acquisition transaction must prepare a bespoke agreement in order to achieve the expected outcome pursuant to their agreed ratchet mechanism. Unlike some other jurisdictions, it may not be feasible under Thai law for the issuance of preference shares or convertible debentures for implementing the ratchet mechanism. With regard to preference shares, the conditions and features of such preference shares are required to be set out at the date of issuance and cannot be straightforwardly altered. The alteration of the conditions of preference shares can be achieved by indirect means through various corporate processes (e.g. capital reduction to remove such preference shares, amendment of the Articles of Association to remove the conditions of preference shares, or capital increase to issue ordinary shares or new featured preference shares in replacement of such preference shares) which may take time.

As for convertible debentures, there are some limitations and certain requirements for the issuance of convertible debentures. In general, convertible debentures must be issued by a public limited company pursuant to the requirements set out by the Office of Securities and Exchange Commission ("**SEC**"). In the case of a private limited company, the SEC has recently allowed a private limited company to issue convertible debentures if such private limited company falls under the definition of SME or startup company set forth by the SEC. For more information on the issuance of convertible debentures by a private limited company, please refer to our earlier articles "*Private Limited Companies can now issue Convertible Ventures*" dated 9 September 2021 and *Part II* dated 8 October 2021.

Given the above, there are other possible options under Thai law that the investor may consider for implementing the ratchet mechanism:

(i) **Reduction of the target company's capital**: For this option, the capital reduction will be effected by way of reduction of the number of shares in the target company held by the party who must reduce their shareholding pursuant to the ratchet mechanism. However, as a result of capital reduction, the return of capital in accordance with the portion of reduced number of shares must be made to the relevant shareholder.

(ii) **Call Option/Put Option**: For this option, the investor or the target company's management will have the right to exercise their call option or put option based on the performance of the business. In this regard, the parties will need to agree on the mechanism for determining the number of shares and the selling price such that the terms and conditions of the call option and put option can be ascertained and recorded in writing. As a rule of thumb, the mechanism of call option / put option is a more common means which generally involves less time and tax consequences.

(iii) **Investment allocation by share capital and loan**: Another option that the investor may consider is to allocate its funds to subscribe or purchase the target company's shares on one part and provide the remainder of such funds as a loan to the target company (as opposed to paying the full amount of the consideration as the share subscription or purchase). The investor may design the conditions for repayment of such loan by way of converting debt to capital e.g. in the case that the target company has underperformed, it must convert such debt into capital in order to increase the shareholding of the investor. On the other hand, in the case that the target company has overperformed, the investor may release the target company's debt payment obligation in favour of the target company or allow the target company to convert such debt to share capital to increase the shareholding of the management. Nonetheless, for the latter, there will be tax consequences on the part of the investor and the target company arising from such debt forgiveness.

Therefore, the investor should carefully consider the pros and cons of each of mechanism, obtain tailored legal and tax advice, and then select which option best suits their particular transaction.

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