

10 QUESTIONS TO A LAWYER ABOUT OPTION AGREEMENTS

One of the most interesting control mechanisms becoming popular among investors is the option agreements, which allow investors to significantly secure themselves and their investments.

Option agreements are well developed in foreign jurisdictions, while the Kazakhstan market has recently got familiar with these underestimated instruments. Investors are most commonly interested in the options granting the right to acquire participatory interests in the Kazakhstan limited liability partnerships (LLP) or, which happens less frequently, shares in the Kazakhstan joint stock companies. Such options are applied in a situation where an investor wishes to become a co-owner of a company when such company reaches specific economic indices or as a security measure in case of violating the obligations by the other party to an option. In this publication, we have prepared answers to 10 most frequently asked questions about option agreements involving acquisition of participatory interests in LLPs.

1. What is an option agreement and what are the types of options?

According to legislation of the Republic of Kazakhstan, there exist the following types of options:

- 1) option (as a financial instrument);
- 2) option agreement; and
- 3) put option.

Option as a Financial Instrument

Option is a derivative financial instrument granting the right, but not an obligation, to one party (option buyer) to buy or sell a basic asset (e.g. shares, participatory interests, property) from (to) the other party (option seller) at an agreed price subject to certain conditions in the future. In turn, the option seller undertakes to fulfil the transaction conditions in case the buyer decides to exercise its right.

Option Agreements and Put Options

Besides a classic option, the Kazakhstan legislation secures two specific varieties of agreements, which are actively applied in venture capital financing:

- 1) **option agreement** is an agreement whereby one party has the right to claim from the other party (or parties) for the fulfillment of certain actions (e.g. payment of monetary funds or transfer of property) within the timeline established by the agreement. Bringing claims into effect may be conditioned by the occurrence of circumstances stipulated by the agreement;

2) **put option** is an agreement whereby one party grants the right to the other party to enter into one or several agreements on the pre-agreed conditions, using the irrevocable offer mechanism.

Options may be classified depending on their conditions and term of exercising:

1. By transaction conditions:

- (i) *put option* – grants the right to sell an asset on the agreed conditions;
- (ii) *call option* – grants the right to an option holder to buy an asset on the agreed conditions.

2. By term of exercising:

- (i) American option – may be exercised at any time during the effective period of an option agreement;
- (ii) European option – may be exercised only upon expiration of the agreed period or in case of occurrence of a specific event.

2. What conditions must be included in an option agreement?

In light of absence of detailed regulation and based on the principle of freedom of contract, when entering into option agreements on the sale of a participatory interest in LLP, we recommend including in such option agreement the following material conditions:

- 1. Information on the basic asset (it is necessary to clearly specify an item serving as the option subject).
- 2. Total value of the basic asset (nominal value of a participatory interest).
- 3. Basic asset price (actual value of a participatory interest in the charter capital of LLP to be paid in case of exercising the option).
- 4. Option premium (fee for granting the right to enter into a transaction in the future).
- 5. Option term (period, during which an option holder may exercise the granted right).
- 6. Option type (in this case, we recommend specifying which exactly option has been granted: put option or call option).
- 7. Option exercise conditions (if necessary) (description of conditions and events, under which the option may be exercised).

3. How can we correctly execute an option agreement to make it legally binding?

In light of the fact that an option agreement is a variety of a civil transaction, to ensure its proper execution the parties must comply with the following universally binding conditions:

- 1) to agree upon all material conditions (conditions specified by us in the Answer to Question 2, including all other conditions, which must be agreed upon in the opinion of one of the parties); and
- 2) to enter into an agreement in a proper form.

In case of an option, it is extremely important to correctly select the form of agreement, since the asset type and/or subject matter of a transaction may affect the applicable form. In light of the option nature, we do not consider the possibility of entering into an option in a verbal form.

An option agreement may be potentially entered into with the participation of the following parties:

- 1) legal entity and legal entity;
- 2) legal entity and individual; and
- 3) individual and individual.

Depending on the composition of the parties and the asset type, different forms of agreement may be applied.

Thus, if both parties to an option are legal entities, the option may be entered into in a simple written form (i.e. by way of simple signing and affixing seals, if any). In this case, it is important to undergo all required corporate procedures established by the constitutional documents of the parties and the target company whose participatory interests serve as the option subject.

If one or two parties to an option agreement are individuals, certain additional requirements will apply to entry into such agreement.

According to the Kazakhstan legislation, an agreement on alienation (assignment) of right to a share in the charter capital of LLP, a party to which is an individual, must be notarized.

In light of the fact that option is a kind of a preliminary stage preceding the acquisition of an asset, to avoid any risks, we recommend notarizing an option, a party to which is an individual, before a notary. If such individual is married, we also recommend obtaining a notarized spouse consent.

4. When option agreements may be invalidated?

Option agreements may be recognized as null and voidable (invalid) based on general grounds established by the civil legislation:

- 1) in case of violating the requirements set to the form, content and participants of a transaction, and to their freedom of the will;
- 2) if the option content fails to meet the legislation requirements (e.g. if failing to reflect the material conditions set out in our Answer to Question 2);
- 3) if an option is aimed at achieving a criminal purpose, illegality of which is established by a court sentence (resolution);
- 4) if an option pursues the purposes of bad faith competition or violates the business ethics requirements;
- 5) if an option has been entered into by a legally incapable or partially incapable person;
- 6) if an option has been entered into as a result of essential mistaken belief;
- 7) if an option has been entered into under the influence of deceit, violence or threat;
- 8) option has been entered into as a result of malicious collusion of one party's representative with the other party; and

9) if a party to an option is an individual who is married and the option has been entered into without obtaining proper consent of the spouse, such option may be invalidated upon a claim from such spouse.

5. Is there any judicial practice relating to option agreements. What is the practice of resolving disputes relating to option agreements?

Option agreements represent a comparatively new mechanism, which has recently started growing in popularity in Kazakhstan. Proper judicial practice has not formed yet; nevertheless, there are several judgments relating to this sphere.

Based on analysis of the available judgments, we may say that, in light of absence of regulations to the contrary, courts classify options as a variety of financial instruments, including the put options for entering into an agreement on sale and purchase of a share in the charter capital of a company (LLP).

According to the available judicial practice, courts generally understand the legal nature of option agreements and rely not only upon the available scarce regulations relating to options, but also upon the key principle of civil law – freedom of contract.

The Kazakhstan courts adhere to the principle of *pacta sunt servanda* with respect to obligations originating on the basis of options, and may obligate one of the parties to enter into a master agreement in case it avoids signing it.

6. What rights and obligations of the parties originate when entering into option agreements?

Option agreements differ from other types of contracts by the fact that they only grant the right to acquire a certain asset on the pre-agreed conditions. Thus, the essence of an option is that one party receives the right to buy an asset, while the other party assumes an obligation to sell it in case of occurrence of certain conditions.

In addition to basic rights and obligations (right to buy and obligation to sell), option may also include other obligations typical for a specific transaction if the parties agree to do so. For example, in case of investment transactions with the use of an option it is possible to include such investor's rights as the right to receive information regarding a company or a restriction on the sale of participatory interests without the investor's consent.

7. What is the procedure for exercising rights under option agreements?

The Kazakhstan legislation does not determine the procedure for exercising rights under option agreements, in which connection this issue is left to the discretion of the parties and must be determined in the very option.

The most popular mechanism of exercising an option is the following procedure:

1. Option agreement includes a condition that, in case of exercising an option, the parties assume an obligation to enter into a sale and purchase agreement on the pre-agreed conditions.
2. Option agreement attaches a model sale and purchase agreement.

3. In case of occurrence of a specific event and exercising the option, the parties sign the sale and purchase agreement and submit it for state registration. If necessary, such sale and purchase agreement is notarized.

4. Governmental authority registers the transfer of rights to a share on the basis of the sale and purchase agreement.

This mechanism is the most convenient and protected, and ensures clarity and convenience to the full extent for all participants to the transaction and registration authority.

8. May option agreements be changed or cancelled by mutual agreement of the parties?

Option agreements, same as other civil contracts, may be changed and/or cancelled by mutual agreement of the parties or in cases established by legislation.

If so requested by one of the parties, an option agreement may be changed or cancelled based on a court judgment only:

- 1) if there is a material breach of the agreement by the other party;
- 2) in other cases stipulated by the current civil legislation or the very option agreement.

9. How can we evaluate the subject of an option agreement in a correct manner?

The subject of an option agreement is a basic asset, which may be evaluated by the parties themselves. The Kazakhstan legislation is silent with respect to requirements on special evaluation of a basic asset (unless such asset is the property requiring mandatory evaluation, for example, immovable property), in which connection in this case it will be necessary to base oneself on the freedom of contract principle.

With respect to participation interests the parties may determine any price they deem appropriate as the purchase price, including the nominal value. If necessary, the parties may also use the "floating" purchase price, the final amount of which may depend on a number of other factors (number of clients, amounts of assets, company employees, etc.).

10. What legal risks pertain to option agreements?

Despite the fact that options have been rapidly growing in popularity, they entail certain risks, which may reduce attraction of this mechanism.

The key point to be mentioned is the lack of proper regulation of options in Kazakhstan. Absence of proper regulation gives rise to the risk of incorrect execution of an agreement (in light of absence of sufficient understanding of the legal nature of an option and specifics of the Kazakhstan legislation, the parties may include many mechanisms and conditions in the option, which may significantly complicate the option exercise procedure, although not being prohibited in Kazakhstan).

A separate important issue is the preemptive right of other participants to purchase a participatory interest in LLP in case one of them enters into an option agreement. The Kazakhstan legislation establishes that the LLP participants enjoy the preemptive right to other persons to purchase a participant's share or any part thereof if any participant decides to sell it. Respect for this right is

accompanied by a set of procedures secured in the Kazakhstan legislation and constitutional documents of LLP.

The Kazakhstan legislation expressly establishes that, in case of selling a share or any part thereof in violation of the preemptive purchase right, any LLP participant may claim in court within three months for the reverse of rights and obligations of a buyer to such participant.

In light of this, in order to exclude the above risk, it is recommended to resolve the issue relating to the preemptive purchase right of other participants before entering into an option. Specifically, it is recommended to obtain written waivers from all other participants of their preemptive purchase rights before entering into an option.