Law360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Punching Above Your Weight: Minority Investments In PE

Law360, New York (August 12, 2016, 11:46 AM ET) --

In recent years, private equity funds have become increasingly willing to make minority investments in private companies. This surge in such minority investing is largely due to a number of macroeconomic factors, including companies' limited access to debt capital and a significant amount of capital held by private equity investors that they are seeking to deploy.

Jeffrey A. Legault

Both private companies and private equity firms reap certain benefits from these minority investment transactions. On the one hand, the sale of a minority interest to a private equity firm allows sellers to maintain control of their company while raising capital and gaining the expertise and credibility that a private equity firm can provide. On the other hand, unlike the competition that is inherent in the auction processes for majority stakes, most minority sales do not involve auctions and therefore, there is less likelihood that a purchaser will overpay for its minority stake in a company.

James West

Furthermore, the fact that many of the companies seeking minority investments are motivated by the need for "growth capital" suggests that such companies have significant growth prospects, specific expansion plans and clear road maps for investing — all attractive qualities to an investor. Private equity firms can also be more confident about a company's prospects since a majority shareholder's desire to maintain control and a significant economic interest in a company is a good indicator of its confidence in the business.

Jordan Lacy

It is our job as attorneys to protect our private equity clients from the downsides of minority ownership while helping them maximize their investment through guiding and successfully exiting a company. This is accomplished through implementation of certain minority protections, some of which are common to all types of minority investments and some of which are more prevalent among private equity investors. These protections are enacted at the board and shareholder levels as well as through certain specialized mechanics, all of which are discussed in detail below.

Preferred Equity

The private equity firm's minority ownership of a company will most likely be in the form of preferred equity with characteristics typical of most minority interests, including (1) liquidation and dividend preferences over other classes of junior equity, (2) mandatory payment in full upon certain events, such as the sale of the company or its initial public offering and (3) a conversion feature that

allows the investor to convert its equity from preferred to common stock.

Additionally, a minority investor will nearly always seek anti-dilution protection. This often takes the form of both a preemptive right to participate in a fresh issue of shares pro rata to the relevant shareholder's current holding, as well as a right to a bonus issue of shares in the event that a fresh issue takes place at a price per share below the initial price per share subscribed by the minority investor.

Board-Level Protections

In addition to such common protections, the private equity investor will also typically seek protection at the board level as it pursues an active management role and looks to create value and drive the business. Although a minority investment usually does not result in control of the board, a private equity firm might request the following rights:

- the ability to appoint director[s] and/or board observer[s];
- certain information rights, including access to budgets, business plans, forecasts and projections; and
- the right to a board seat on the audit and remuneration committees.

Shareholder-Level Protections

At the shareholder level, the private equity investor customarily enjoys certain veto rights, the scope and number of which typically reflect the extent of its economic interest, but in any event, should cover most material actions proposed to be taken by the company. One advantage of placing the controls at the shareholder, rather than the board, level is that while a director must act in the best interests of, and has fiduciary duties to, the company, a minority investor, as a shareholder, is not restricted by any similar constraints and may vote its shares in its sole discretion to maximize its own interests. Such veto rights generally cover matters such as:

- amendment of governing documents;
- issuance of new securities;
- significant transactions including acquisitions and dispositions of assets outside the ordinary course;
- sale or winding up of the company or other change-of-control transactions;
- capital expenditures in excess of a specified amount;
- incurrence of debt in excess of a specified amount;
- entry into a new line of business;
- alteration of board size or composition;
- termination or selection of senior management;
- entry into management incentive arrangements or employment agreements with senior management;
- transactions with affiliates; and
- adoption of or changes to financial budgets.

Step-In Rights

Irrespective of its minority position, the private equity investor may want the ability to take control of

the company (in the form of “step in” rights) in the event that the company is performing poorly. “Step in” rights are typically triggered by a number of predetermined events, including poor financial performance (based on specified thresholds), breaches of financial covenants in financing arrangements, loss of key management, or material breaches of the shareholders’ agreement and/or shareholder loan note documents. As with veto rights, the ability to insist on this protection is generally related to the investor’s percentage stake in the company and/or the respective bargaining strength of the parties.

The “step in” rights of the private equity investor will vary and range from the ability to approve and enforce emergency business plans and actions to the right for the investor to take control of the board. Such rights will typically fall away once the relevant set of facts leading to the trigger have been reversed. Alternatively or additionally, a minority investor might be able to push through any actions it deems necessary to rectify the relevant issue simply through the voting rights that attach to its shares in the company.

Exit Strategies

In a typical majority investment, the private equity investor makes the sole determination as to the timing and form of an exit from the company. However, in a minority investment, the private equity investor will not automatically control the exit process. Moreover, the private equity investor might be the only seller while the majority shareholder wishes to retain its interest in the company. As a result, the private equity investor should set forth in the shareholders’ agreement a clearly defined process for exit which includes:

- a general obligation on the board/shareholders to pursue an exit (in the form of a sale or IPO) within a given time frame or upon the occurrence of specified events similar to the triggers for “step in” rights. In the event of such an exit, the private equity investor often has the right to appoint advisers and bankers for the company and to participate in discussions relating to an exit;

- drag-along rights to enable the parties to sell their shares to a third party upon certain terms and conditions and to compel the other shareholders to sell with them upon the same terms, which rights are only effective in limited instances, such as upon the approval of a supermajority of stockholders or if the net proceeds of such sale will exceed a predetermined threshold amount;

- tag-along rights, which give the shareholders a right to tag their shares to any permitted third-party sale upon the same terms as those offered to the other selling shareholders; and

- “put rights,” which allow the private equity investor to liquidate its interest in the company by selling its shares to the company or the other shareholders at a certain price and at a certain time, such as a predetermined date or upon the occurrence of specified events similar to the triggers for “step in” rights.

Conclusion

By implementing adequate protections as discussed above, a private equity investor can be confident in its minority investment in a company while the company reaps the invaluable benefits of the investor’s guidance and expertise, and as a result, both parties can enjoy a mutually beneficial and prosperous relationship.

—By Jeffrey A. Legault, James West and Jordan Lacy, Mayer Brown LLP

Jeffrey Legault is a partner in Mayer Brown's New York office. James West is a partner in the firm's London office. Jordan Lacy is an associate in New York.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2016, Portfolio Media, Inc.