In recent years we have seen more of our private equity clients entering into a range of minority investments. This update provides a summary of some of the standard rights and protections being sought by private equity investors as part of their minority investments.

**Board Level**

Whilst it is likely that many funds will be pursuing an active management role, looking to create value and drive business, it is highly unlikely that a minority investment will come with control of the board. Indeed, whilst many minority investments will have as one of their foremost drivers the provision of particular skill sets by the fund investor, including M&A and IPO experience or access to international markets, this comes without the ability of the minority investor to force such advice upon the investee company. Rights at board level are likely to include:

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

**Shareholder Level**

Whilst the minority investor will typically not require control of the board, it customarily enjoys certain veto rights at shareholder level, the scope and number of which typically reflect the extent of its economic interest. One advantage in UK companies, of putting controls at shareholder, rather than board, level is that whilst a director must act in the best interests of, and has fiduciary duties to, the company, the minority investor, as shareholder, is not restricted by any similar constraints and may vote its shares as it sees fit in its own interests. This may vary according to the jurisdiction. Veto rights include matters such as:

- the amendment of governing documents (articles of association);
- significant transactions by the investee company including acquisitions, disposals, financing, material litigation and appointments;
- the issue of new securities; and
- the winding up of the company or significant changes in its business.
Step in Rights

Irrespective of its minority position, the private equity investor may want the ability to take control of the company in the event that things are going badly. As with the veto rights, the ability to insist on this protection is usually related to the percentage stake in the company and/or the respective bargaining strength of the parties. This right may be triggered by a number of pre-agreed events, including poor financial performance (based on pre-agreed thresholds), breaches of financial covenants in financing arrangements or material breaches of the shareholders’ agreement and/or shareholder loan note documents.

The rights of the minority investor upon such events occurring will vary and will range from the ability to approve and enforce emergency business plans and actions, to the right for the minority investor to take control of the board (“swamping rights”) and, often, the voting rights attaching to the shares in the company in order that the minority investor can push through any actions it deems necessary to rectify the relevant issue. The “step in” rights will usually fall away once the relevant set of facts leading to the trigger have been reversed.

Anti-Dilution

A minority investor will nearly always look for anti-dilution protection. This will often take the form of both a pre-emptive right to participate in a fresh issue of shares pro rata to the relevant shareholders 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.

Exit

In a typical majority investment, the private equity investor makes the sole determination as to the timing and form of an exit. In a minority investment the minority investor will not automatically control the exit process, and indeed is often the only seller, with the majority wishing to remain. A minority investor must therefore seek to set out in the shareholders’ agreement a clearly defined process for exit which will include:

- a general obligation on the board/shareholders to pursue an exit within a given timeframe. This often includes the right for the minority investor to appoint advisers/bankers for the company and to participate in discussions relating to an exit (sale or IPO);
- drag along rights giving the parties the ability to seek a sale of their shares to a third party after a given period of time and to compel the other shareholders to sell with them upon the same terms;
- tag along rights giving the shareholders a right to tag their shares to any permitted third party sale upon the same terms; and
- “put rights” that allow the minority investor to put its shares onto the other shareholders at a certain time and at a certain price per share.

EU Merger Controls

When the sponsor invests in a particular industry segment, an industry where perhaps it may already be an investor, the activities of the investee company may need to be aggregated with those of the investor’s prior investments for the purposes of EU merger controls. To be clear, this will only be relevant if the minority investor obtains “control” of the investee company through its minority investment. Under EU merger control rules, control is defined as the ability to exercise “decisive influence” over an entity, which typically would require an ability to influence (e.g. via a veto right) one of the following: the budget, the business plan, senior hires and fires and investments (where the thresholds for these are set at a level where the veto is likely to allow control over day to day operations). These veto matters are, of course, standard fare for minority investors. As such, care should be taken in considering whether the minority investor has businesses which compete with the investee company in its existing portfolio and, if so, whether the EU merger control rules might apply to such minority investment.

Market Update | Punching above your weight - Minority Investments in Private Equity

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