fact sheet

Private Equity: What to look out for in the Legal Documents

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Preliminary

At some stage in their history, most private companies will require access to external funding. The money may be needed to finance growth, for example through the development of new products or expansion into new markets, or it may be used to allow existing shareholders to realise some of the value created by their past efforts and to incentivise a new tier of owner-managers.

External funding can come from a variety of sources and in a variety of forms but, in the simplest terms, it will either be debt or equity. Debt funding, in the form of bank loans, is the most obvious and straightforward way of raising finance but there may be several reasons why this is either unavailable or unappealing, particularly in the current economic climate. The company may have insufficient assets to satisfy the bank's requirements for security or the cost of borrowing may be too much for the Company's cashflow to bear.

This may lead the company to consider raising money by issuing shares to a new investor. Depending on the size of the company, the amount of funding required and the nature of the transaction proposed, the source of such an investment can range from business angels (acting alone or as a consortium) to established private equity providers.

Regardless of the type of equity funder, however, the principal investment documents will be the Investment Agreement and the new Articles of Association.

Investment Agreement

Purpose

The Investment Agreement has two main purposes. It sets out the mechanics of the transaction being undertaken – i.e. the number of shares to be issued, the price at which they are subscribed for and the parties to whom they are issued. It also describes the ongoing contractual relationship between the investor and the company's management (and any other non-management shareholders).

Conditions

Completion of the Investment Agreement (and therefore of the investment) will be subject to several pre-conditions. These may include the satisfactory completion of the investor's due diligence, a reorganisation of the company's share capital and putting in place keyman insurance for certain directors.

Warranties

The company and the managers will be expected to give warranties to the investor under the Investment Agreement. The nature and scope of those warranties will differ according to the size of the transaction and the extent of the company's history. The managers will be asked to warrant that the information provided to the investor during the due diligence process and perhaps also to give warranties in relation to reports prepared for the investor by third parties, such as an accountants' report.

If such reports are warranted by management, the warranty should be limited to factual matters and the management should consider the report carefully and disclose any inaccuracies. The liability of the company and the managers under the warranties will be limited both in time and amount. For the company, the maximum liability is usually equal to the amount of the investment, whilst managers are usually able to limit their liability to a multiple of their salaries.

Information and Representation

The Investment Agreement will set out the information which the investor expects the company to provide. This will include monthly or quarterly management accounts and cashflow statements and will generally be more comprehensive than the information the company currently complies or which it is required to produce by law. The Investment Agreement will also address the investor's right of representation on the board of directors. The investor will usually require the right to appoint (and remove) at least one director and, in larger companies, dictate the make-up of committees such as an audit committee or remuneration committee. The investor may also have the right to appoint an observer, who attends at board meetings but does not vote. This is useful where no investor director has been appointed and the investor does not want to put one of its own employees on the board.

Investor Consents

The Investment Agreement will contain a list of matters which require the consent of the investor or the investor director. These will range from operational matters, such as entering into contracts above a certain value or recruiting new employees with salaries above a set level, to more fundamental matters such as issuing new shares or changing the articles of association of the company. The managers should seek to ensure that the suite of investor consents does not unduly hamstring the day to day running of the business and, where consents are required; the procedure for obtaining consent is as efficient as possible.

Restrictive Covenants

The investor will require the managers to enter into covenants not to compete with the company once they cease to be an employee or director. Although similar covenants may be contained in the managers' service agreement, the covenants given in an investment agreement are generally accepted as being easier to enforce, particularly where a payment is made to a manager for his shares on leaving the company. The managers should try to negotiate covenants which are no more onerous than those in their service agreements.

Exit

An investment agreement may contain provisions relating to the investor's (and the managers') eventual exit from the company. Whilst the agreement cannot sensibly bind the parties to sell the company at some point in the future, it may set out the general timeframe for an exit and perhaps deal with the appointment of a corporate finance adviser to market the company for sale. The agreement will also state, in advance, that the investor will not give warranties on an exit, except as to ownership of their shares.

Articles of Association

An investor will usually subscribe for a different class of share from those held by management. The various rights of the different company's classes or shares will be set out in the articles of association.

Dividends and Redemption

The shares held by the investor may carry the right to a fixed dividend (calculated as a percentage of the amount subscribed for the shares) or a participating dividend (calculated as a percentage of the profits of the company) or a combination of the two. The investor's dividends will be expressed as cumulative, so if the company is unable to pay a particular dividend then it will be rolled up and paid in the future, in preference to any later dividends. The investor's dividends will always be paid before any dividends on the managers' shares. In fact, the articles often state that no dividend may be paid on the managers' shares without the consent of the investor.

The shares held by the investor will often be redeemable at a set point in the future (particularly if they are preference shares). This guarantees the investor at least a partial exit after a fixed time. On redemption, the investor is repaid the amount it subscribed for the shares in question plus, in some cases, a premium.

Liquidation Preference

The liquidation preference sets out the rights of each class of share to receive capital on a liquidation of the company or on a distribution of assets, such as following a sale of the company's business. The investor will be entitled to be paid out before the managers and will receive the subscription amount for both its preference shares and ordinary shares, together with any unpaid dividends. Only after all these amounts have been paid will the managers be entitled to any payment.

Ratchets

Ratchets are used as an incentive to management to maximise the return to the investor. They allow the managers to increase their percentage shareholding in the company, usually by converting some of the investors' shares into worthless deferred shares. The operation of the ratchet is triggered by the investor achieving a pre-agreed rate of return on its investment within a certain timeframe or by an exit being achieved at or above an agreed price. Ratchets must be carefully drafted and managers need to be wary that any ratchet does not have any adverse consequences for their personal tax position.

Share Transfers

An investor will often state it is backing the management team as much as the company, and so they will seek to ensure that the managers remain committed to the company by severely restricting their ability to transfer shares. The usual starting position is that the managers may not transfer their shares other than to certain permitted transferees or by offering them to other shareholders through a pre-emption process. Permitted transfers are generally limited to transfers to family trusts or close family members. Where shares are to be offered by a pre-emption process the key points to be negotiated are the price at which they are offered and the order they are offered to other shareholders. For example, should shares being offered by one of the management team be offered to other managers before the investor?

The articles will also stipulate that any manager who leaves the company is required to offer his shares for sale. This issue of what price he receives for those shares will be determined by whether he is deemed to be a "good leaver" or a "bad leaver" by the articles. A good leaver will be allowed to offer his shares for sale at their market value (usually set by an independent accountant) whilst a bad leaver will be required to sell his shares at their normal value. In an ideal world, the managers would like the definition of "bad leaver" to be limited to those who are dismissed for fraud or misconduct. However, the investor is likely to demand that various other situations are included, such as dismissal for underperformance or leaving for any reason (other than ill-health) during a set period following the investment.

The articles may also include "drag-along" provisions, which allow shareholders owning a certain percentage of the company's share capital to agree to sell their shares to a third party and then compel the remaining shareholders to do likewise. The issue of what combination of shareholders can trigger the drag-along is one for negotiation, but the investor will resist any provision under which it may be forced to sell its shares against its will.

Having an experienced team gave me real peace of mind to concentrate on running the company as the sale process took place. The sale worked out well.

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