CONSIDERATIONS For Minority Equity Interest Owners

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Investors with a minority equity interest in closely held companies require a variety of legal protections relating to the general operations of the business. These owners typically have limited control over the management of the company, as they often do not have enough voting power to influence actions the company may take.

In addition, these investors most likely will not have a real market in which to sell their equity, and accordingly, should provide themselves with an adequate exit strategy upon the occurrence of certain events or after a certain amount of time has passed to ensure some return on their investment.

While there are many areas of protection that minority interest investors should consider, the following will focus on several standard protections, often called “minority protections,” as well as several methods of equity redemption, these investors should consider as potential exit strategies.

Minority Protections
There are several ways minority investors in closely held companies can ensure that they are able to participate in overseeing the material operations of the business and have a voice in making other significant business decisions. Typically, a minority owner may ask for a board seat or board observer rights, which would give the investor significant participation in the operations of the business.

However, simply having a seat on the board usually will not allow a minority investor to obtain sufficient control to influence the decision-making process. As a result, these
If they want additional protections, minority investors should insist that certain actions require their consent.

For example, they may want consent rights when the company decides to borrow money or relocate the firm’s primary offices.

Transactions. Minor investors will often demand language in the company’s operating agreement or shareholders agreement that requires approval by the minority investor before the majority owner or the company can take certain material actions.

These protections are generally designed to protect against the company incurring significant liabilities or other major transactions without a minority investor’s consent. These provisions can also help protect against poor business management decisions, and may result in preserving the value of the minority owner’s investment.

Transaction Protections. Minority investors may want approval rights relating to material transactions of the company. These transactions could include: a sale of the company (by asset sale, stock sale, merger, liquidation or other corporate transaction); any acquisition by the company of the stock, assets or business of another entity; any investment by the company in another entity; or the formation of any subsidiaries.

Such protective provisions allow the minority investor to prevent any major acquisition or disposition by the company or any other transaction relating to corporate structure if the minority investor believes that such a transaction would not be in the best interest of the company.

In addition, consent of minority investors can be required in connection with the issuance or sale of any senior or pari passu class of equity, the reclassification or change in the rights of any such class of equity or the issuance or sale of options or other convertible securities for such class of equity. (Pari passu refers to a series of equity that will have the same rights and privileges as another series of equity.)

Minority investors should request this approval right to maintain an ownership position without fear of dilution and to prevent the creation of more senior or pari passu equity.

Significant Management Protections. In most cases, minority investors do not have the ability to make general management decisions, including decisions relating to personnel and business strategy. Absent a board seat or certain pre-negotiated contractual protections, a minority owner essentially has very limited control over the material operations of the business.

Though minority investors may have certain statutory protections that protect stockholders generally, most significant actions of the company require only board approval or — at most — approval by a majority of the equityholders.

Therefore, if they desire additional protections, minority investors must insist that certain actions require their consent. They may want consent rights regarding the incurrence of debt for borrowed money, deviation from the approved annual operating budget or capital expenditure budget or relocation of the company’s primary offices.

In addition, minority investors may want consent rights for the hiring or firing of any key employee or the change in salary or bonus compensation of any key employee.

Also, to maintain their ability to oversee its investment, minority investors should demand certain information rights, such as the right to review the company’s books and records and to receive financial statements and the operating budget on a periodic basis.

Miscellaneous Protections. Finally, there are various other actions for which minority investors may also want consent rights.

These include: amending or modifying the company’s organizational documents; changing the company’s name; entering into modifying, terminating or renewing any real property lease or any other material agreement; and entering into any affiliated transactions including making loans to employees or amending or modifying the company’s employee benefits and compensation arrangements.

Exit Strategies

Investments made in securities of a private company may have a very limited market through which a minority investor can sell its equity. Despite limited channels to sell such equity, investors in private companies often desire to further restrict any sale or transfer through contractual obligations.

Transfer restrictions help maintain the same group of investors and preserve any existing goodwill or inter-relationships among them, which may have a meaningful impact on the company’s ultimate success and the minority owner’s continued investment.

For example, in a strategic investment, a minority investor may want to prohibit transfers to a competitor of the company. Thus, in light of these contractual transfer restrictions and lack of a public market for sale, it’s important to negotiate an exit strategy before acquiring a minority interest in a private company.

Right of First Offer. Owners of minority equity interests in a closely held company often negotiate transfer restrictions subject to a right of first offer. Right of first offers can be structured to require the majority owner — in the event it desires to sell its equity — to first offer the equity to the minority investor on certain
The investor may elect to purchase the offered equity and, in effect, has the ability to prevent the majority owner from selling its equity to a third-party. If the minority investor does not elect to purchase the equity offered for sale, the majority investor would be allowed to sell to the third-party, subject to certain terms and conditions.

**Tag-Along Rights/Drag-Along Rights.** Minority investors should strongly consider requiring the operating agreement or shareholders’ agreement to include a “tag-along” provision. Such a provision can be structured to afford minority investors the right to participate in a sale of equity by the majority investor on the same terms and conditions.

This allows minority investors to decide whether they want to remain an owner of the company in the event a majority of the equity changes hands. If the investor is not willing to remain a co-owner with the proposed third-party purchaser, the minority investor can elect to exercise its tag-along right and participate in the sale to the third-party.

Often a majority investor requires a “drag-along” provision, which would require the minority investor to participate in a sale of the company. A majority investor will desire to secure this right, because it does not want a minority investor to be able to prevent a sale.

To protect itself from being “dragged” into a less-than-ideal sale transaction, the minority investor should make the “drag-along” provision effective only upon approval by a supermajority of stockholders or, perhaps, only if the net proceeds of such sale will exceed a predetermined threshold amount.

In addition, the minority investor could ask for a “right to first negotiate,” pursuant to which the company would be required to exclusively negotiate a sale of the company with the minority investor prior to any negotiations with third parties.

**Put Option.** In certain circumstances, a put option may be a suitable exit strategy for minority investors in closely held companies. Such an option allows the minority investor to require the company or the majority owner to purchase its equity upon certain terms and conditions. A typical put option is generally not exercisable until a period of time has lapsed or until certain milestones are achieved to give the company an opportunity to grow and mature its business before a meaningful value can be attributed to it.

This factor would ultimately affect the put option purchase price, because typically the purchase price is calculated based on a formula that takes into account a designated financial measure such as net income, revenue, EBITDA [earnings before interest, tax, depreciation and amortization] or revenue growth rate, or other operational metrics (such as the number and strength of the clients, build-out phases or Web analytics).

In addition, a multiple (a variable number depending on the growth rate of the business) may be applied to such financial measures. Alternatively, if the minority investor has a strategic interest to fully own the company, a call option can be structured whereby the minority investor would have the right to purchase the equity owned by the majority investor.

**Other Trigger Events.** Minority investors may desire a prearranged exit if the company fails to achieve certain financial thresholds or in the event a founder or key executive of the company were to leave the business.

The minority investor may want the ability to sell back its equity to the majority owner if the business’ performance falls below a certain level or its success is impaired because certain critical personnel are no longer involved in the day-to-day affairs. This right may not be appropriate for a passive investor, because a passive investor is likely to be required to bear some risk of failure.

But in a strategic alliance or joint venture, this right may be warranted. Alternatively, if the minority investor has a strategic interest to fully own the company, the same trigger events could be structured to give rise to the investor’s right to buy out the majority investor at a discounted price.

It is important for investors owning a minority interest in a closely held company to obtain contractual protective rights to maintain a certain level of control over the operations of the business. In many instances, these protections afford minority investors their only ability to influence management and prevent the company from incurring significant liabilities or entering into major transactions.

In addition, these investors must be aware of certain methods to provide beneficial exit strategies. Minority investors should consider various exit strategies and transfer restrictions that will allow them to be adequately protected while preserving the right to divest the investment under favorable terms and conditions.

**Minority investors may want a prearranged exit if the company fails to reach certain financial thresholds or in the event a founder or other key executive leaves the firm.**

The investors also may want the ability to sell equity back to the majority owner if the company’s performance falls below a certain level.

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