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CORPORATE ADVISORY

More Money, More Problems: Providing additional capital to UK companies in turbulent times

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The UK economy continues to deal with significant upheaval, and the outlook for investors holding significant equity stakes in UK portfolio companies is increasingly hard to predict. A change in the trading relationship with the EU, the fallout from the COVID-19 pandemic, continuing widespread inflation, an increase in global energy prices, rising interest rates and turbulence in international banking markets have all contributed to this challenging environment.

It remains unclear how long this combination of factors will take to stabilise. In this note, we consider some key points for equity holders to consider in turbulent economic times.

Putting in more money: general considerations

- The recent tightening of the debt markets may mean that more UK portfolio companies have to raise equity funding, either for acquisition capital or to cure or prevent a covenant breach. In such a situation, investors providing further equity need to consider their options carefully.
- One point to consider early on is whether pre-emption will apply. The terms of any relevant shareholders' agreement and of the articles of association should be checked to ascertain whether a majority shareholder is entitled to put more equity financing in without a *pro-rata* pre-emption process being followed and what priority will attach to any new capital.
- Majority shareholders must also consider whether the minority shareholders will wish to participate in any funding round, or whether they will be diluted. In situations where additional funding is urgently required, a well-capitalised shareholder could gain a significant stake by being the only shareholder ready to invest at speed and at a price per share acceptable to the company. However, minority shareholders often benefit from a catch-up right which should be considered as part of the overall economics of the deal.
- Conversely, majority equity holders with sufficient cash to provide funding may wish to provide it in the form of debt at a higher coupon rather than as equity, in order to rank superior in the event of a subsequent insolvency. Whether doing so is possible will likely depend on the terms of any existing third-party debt. Investors should also consider whether the debt should convert on exit to allow investors a share in any equity upside.
- Investor directors should consider their duties to the portfolio company and be aware of the potential for conflicts of interest to arise on the issue of further shares to, or the entry into any loan agreements with, their appointing shareholder. Any such director may be required to recuse themselves from discussion of or voting on these matters, depending on the terms of the company's articles as to director conflicts.

The impact of further equity on management

- Any dilutive equity investment will affect expected returns for all shareholders, including members of management holding shares (whether under an incentive scheme or otherwise). As a result, management may be unwilling, or at least unhappy, for further shares to be issued to a majority holder.

- Majority shareholders should therefore review the tools available to them in the event of a dispute with management, but in doing so, weigh the consequences of using them. Seeking to impose unsatisfactory terms onto the directors of a company may cause them to resign rather than be forced by the shareholders to act in a way that they consider is not in the best interests of the company.
- Investors should consider their rights in respect of further issues contained in any shareholders agreement. Many shareholders' agreements allow further issues of equity with the consent of a specified majority, and certain agreements allow shares to be issued in an emergency situation without the need for otherwise necessary consents.
- Further, many company's articles of association (including Article 4 of the Model Articles) allow shareholders holding 75 percent of the votes in general meeting to direct the directors to take, or refrain from taking, a particular action. This can be a powerful tool. Shareholders' Agreements may contain similar wording allowing a defined majority to approve changes or reserved matters, but investors should confirm this before taking any action.
- In more extreme cases, shareholders can by simple majority remove a director by following the statutory process in section 168 of the Companies Act 2006. Of course, shareholders wishing to remove a director in such a manner should consider the possible consequences of doing so on business performance and morale more broadly, and it may not be palatable to any involved party to remove the management team of a portfolio company.

Investing further equity: drag along rights

- Many company's articles of association contain a right for a shareholder acquiring a certain percentage (often 50, 60 or 75 percent) of the share capital to compel the remaining shareholders to sell their shares on the same terms. An issue of further equity where certain investors participate and others do not may change who holds the requisite percentage — for example, in a situation where two sponsors hold equity and a further issuance is not pre-emptive, control may switch from one investor to the other.

Providing debt financing: potential downside protection

- If permissible under the company's existing financing agreements, majority shareholders could provide further funding as debt. Any further debt financing will likely require the consent of the company's existing lender, and investors should expect to rank behind the existing senior lender. Similarly, any security arrangements will need to be agreed with existing lenders and will be subordinated to their interests. This subordinated status will, however, most likely increase the interest rate on the debt provided.
- It is likely that taking on debt will be a reserved matter under any shareholders' agreement, and therefore the requisite consent will need to be obtained. As noted above, it may be possible to proceed without the unanimous consent of the board or the other shareholders, depending on the terms of the company's constitutional documents.
- Alternatively, investing by way of Convertible Loan Notes (CLNs) can provide a helpful mechanism for investing further cash without requiring the company (or its investors) to crystallise a devaluation of its shares by undertaking a downround. Well-structured CLNs provide the downside protection of being a creditor whilst also allowing investors to benefit from some of the upside of equity holders by way of a discount on a future fundraise or conversion at a valuation cap on an exit.

Strengthening the balance sheet: debt for equity swaps

- The rapid change in the availability and cost of capital in recent months will have left a number of promising investee companies facing unanticipated financial difficulty. Companies needing to refinance existing facilities will feel this especially keenly. A debt-for-equity swap can assist such companies in advancing through a difficult period and can lead to significantly increased returns for investors.
- Majority shareholders who have not provided any debt should be wary of the potential dilution that will likely accompany a debt-for-equity deal between a portfolio company and its lenders. Creditors, including any sponsors

who have invested debt, will expect preferential equity terms and to receive as great a proportion of the voting capital of the company as possible in return for the debt obligations.

- It is likely that shareholder consent will be required for any deal to go through (either through the provisions of a shareholders' agreement or because the company needs shareholder authority to allot the relevant equity), and therefore a majority shareholder will be able to influence the terms of any debt for equity swap.
- However, shareholders should be wary of short-termism and defensiveness. If a debt-for-equity swap constitutes the best route to rescue an otherwise promising portfolio company, blocking it to avoid being diluted by an incoming lender may not be the best approach in the long term.
- If shareholders are open to the possibility of a debt-for-equity swap, from a tactical perspective, it would be sensible to present a proposal to the company's lenders and to do so well in advance of the company triggering any enforcement provisions in its finance documents. This would allow shareholders to retain some control over the outcome of the deal, as compared with a process that is entirely led by the lender or a process that begins after the lender has obtained actionable enforcement rights.
- In addition, any debt-for-equity swap involving the issue of preferred shares should be considered carefully. Detailed tax advice should be sought on any restructuring of company debt.

Check the constitution: a recent dispute around conversion rights

- A recent High Court decision in a dispute between a private equity sponsor and one of its portfolio companies illustrates the need for investors to review carefully the articles of association of portfolio companies and associated shareholders or investment agreements. When economic conditions change, provisions that seemed to have an obvious intent when they were written can become subject to varying interpretations or to previously unforeseen uses.
- In this case, the sponsor held preferred shares, providing a preferred dividend and a preference on a return of capital. Under a shareholders agreement with the other shareholders and the company, the sponsor also had a put option to require the company to repurchase all of its preferred shares in the event that an IPO with an offer price of at least £900m had not occurred by a particular date.
- The portfolio company became concerned that in the event the company was obliged to purchase shares pursuant to the put option, doing so may have a materially adverse effect on the business, financial condition and prospects of the company. So, it exercised a right to convert the investors' preferred shares into ordinary shares without their consent, purportedly under authority from the articles of association. This conversion extinguished the preferred rights attached to the shares and also the put option itself.
- The sponsor challenged the exercise of the conversion right. The court found in their favour and blocked the conversion as an unauthorised variation of the rights attached to the preferred shares. The company has indicated that it intends to appeal the decision.
- This dispute should serve as a cautionary tale to equity holders. The conversion right exercised in this case was most likely included as a catch-all mechanism to allow the company to convert all shares into ordinary shares on an exit. However, as a result of the company's changed financial position, it became a purported device to be used against the sponsor. Clear drafting at the time is obviously the best way to avoid such situations. However, a timely review of constitutional documents to identify any potentially problematic or ambiguous provisions will allow investors to propose clarificatory amendments before any issues arise.

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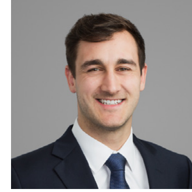

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