



## Client Advisory

### Illiquid Investments—Principal Minority Protection Rights

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#### Introduction

The purpose of this advisory is to highlight the main types of contractual minority protection rights typically associated with minority investments in UK private companies and other issues to be considered when implementing such illiquid investments.

Not all of the protections listed below will always be appropriate, and in some cases, investors may take the view that they are investing primarily in the skill and experience of the management team who should be left to make the decisions. In these cases, minority protection is often kept at a minimal level. However, other investors may be more cautious and insist on greater protection.

Contractual minority protections would typically be set out in either the company's articles of association or a separate shareholders' agreement. Publicity and enforcement issues may dictate where the protections are agreed. In the UK, articles of association are publicly available and can be amended by a 75% vote, whereas a shareholders' agreement, although a private document, may require unanimous or majority investor consent to amend.

It may also be worthwhile to mention that the default position for UK limited companies is for all shares to have a voting right (unlike offshore jurisdiction fund companies) and for those voting rights to reflect the percentage of the issued share capital held (not necessarily on a fully diluted basis).

#### Minority Protections

- **Principal Areas of Concern—to Ensure:**
  - involvement in major decisions (board representation and rights of veto);
  - protection against equity stake being diluted;
  - appropriate distribution of profits;
  - adequate access to information; and
  - ability to exit.
- **Corporate Governance**
  - entitlement to director(s). In the UK, directors can be removed by ordinary resolution (a resolution that is passed by a simple majority), so weighted voting rights may be required (on a resolution to remove a director appointed by a certain class of share that class is deemed to have a sufficient number of votes to defeat that resolution if it chooses);
  - observer/membership rights on subsidiary boards and committees;
  - information rights (receipt of audited/management accounts, business plan and budget, notice of offers for the company and material assets, notice of material litigation and right to examine books, records and accounts, particularly where the company is distressed); and
  - agreeing on a business plan or budget to which the management must stick (unless the investors consent).

- **Veto Rights—Consider:**
  - changes in the company’s articles of association;
  - new issues of share capital (including grant of share options);
  - significant changes in nature of the business;
  - major acquisitions or disposals;
  - capital expenditure or contract commitments in excess of pre-agreed limits;
  - changes to the business plan or budget;
  - borrowing limits and security packages;
  - dividend policy;
  - appointment and dismissal of key management;
  - material dealings with intellectual property;
  - dealings between the company and its shareholders (except arm’s length dealings in the ordinary course of business); and
  - other specific veto rights that may be appropriate.
- **Anti-dilution**
  - pre-emption right on new issues of shares on a pro-rata basis; and
  - down-round protection (if there is an issue of further shares at less than the subscription price paid by the minority investor, e.g., the right to subscribe for additional shares at nominal value or a conversion right into the new shares).
- **Transfer Restrictions**—Transfers are subject to pro-rata pre-emption rights (other than customary exceptions, such as defined permitted transferees or where drag/tag along rights apply).
- **Drag/Tag Along Rights**
  - **Drag Along:** On any proposed transfer of shares which would result in a sale of the company (transfer of >50% of shares—but consider higher or lower triggers), transferee(s) shall have the right to require remaining shareholders to sell their shares on the same terms and conditions.
  - **Tag Along:** Other than where a transferor has exercised a drag along right, on any proposed transfer of shares which would result in a sale (consider again the appropriate triggers, e.g., >50% of shares or a transfer by key management of their stake), the other shareholders will have tag along rights to sell all/the same proportion of their interests to the purchaser.
- **Warranties**—Management/key existing investors are to provide commercial (including tax) warranties. Information relating to any previous claims made under the warranties should be disclosed and assurances obtained that no additional claims are expected to be received by the company or made by the investors.
- **Preferential Rights**—Investors often seek preferential rights to income/gains from a company. These rights would entitle the investor to a preferential dividend/distribution (which could include a coupon) in the event that the company has distributable profits available (which could be rolled-up in the event that there are insufficient distributable profits in any year). Please note that this is not a quasi-debt right—in the event that there are no distributable profits, there will be no dividends/distributions—all the investor can ensure is that if it does not receive its preferential return, then the other shareholders will not receive any distributions.
- **Exit**—Agreement to work towards a sale or IPO within a fixed period. No exit should occur without investor consent (and/or where the investor does not receive a stated minimum return). Exit covenants should include exclusion of warranties or representations on an exit by the investor and agreement by parties to customary lock up arrangements. Consider inclusion of registration rights if a US IPO is contemplated.

- **Fees and Expenses**—So far as lawful, the company is to pay all reasonable expenses and other professional fees (plus VAT if payable thereon) (on a full indemnity basis) incurred by or on behalf of the investor in connection with its investment. Consider any additional arrangement fees, if appropriate.

The overall aim should be to ensure key management is not prevented from maximising the investment potential of the company in the interests of founders and investors alike, but to create a framework which protects the investor whilst allowing management to succeed.

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