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The Noncontrolling Investment And How To Protect It

Law360, New York (July 01, 2009) -- Current economic times have changed the landscape of private equity investing.

In the past, both private equity funds and strategic investors have generally avoided taking a minority position in a company for myriad reasons, most importantly of which was the limited control that the investor would have in directing the ongoing operations of the target.

Now, with the shrinking leveraged buyout market, minority investments are becoming more common and, if done correctly, can be a lucrative investment. A proper minority investment should include the following:

Due Diligence

Without exception, the investor should conduct a thorough business, legal and financial diligence review of the target. There is no substitute for taking extra time to conduct such a review.

After all, while the investment agreements may be clear, if an issue does arise post-closing the investor would likely be filing a claim for indemnification against the target's management team, a difficult proposition indeed.

Compatibility Analysis

The investor also needs to be comfortable that the interests of the target's management and the investor are properly aligned.

Proper incentives should be put in place in order to prevent the management team from becoming complacent or ambivalent, or just not putting forth the same effort, after the investment closes.

At the end of the day, the investor needs to remember it is investing in both the company and the existing management team.

Exertion of Influence

Even though the investment is a minority position, the investor can retain a sufficient level of influence over the operations and strategy of the target post-closing. In order to do so, the investor, at a minimum, should negotiate for the following items.

- The Board. The investor should seek to have one or more representatives on the board of directors of the target (and, preferably, on any major committees of the board).

The investor should also have input as to the composition of the board. The board should include outside, independent directors who can bring real industry experience and tangible value to the target.

- Approval Rights. The investor should have approval rights with respect to material decisions of the target. These rights are not intended to usurp the power of the target's board, but merely to ensure that the investor has input on decisions that may adversely impact the investment or the target's core business.

An example of these rights include: (1) entering into any acquisition, merger, or recapitalization; (2) incurring or guaranteeing any indebtedness in excess of a predetermined amount; (3) voting to dissolve or liquidate, (4) hiring, firing, or increasing the compensation or benefits, of any employee, (5) approving the annual budget and (6) entering into any material contract in excess of a predetermined amount.

These approval rights need to be granted to the investor in its capacity as a shareholder and not as a board member due to the fiduciary obligations that a board member owes to the target and its shareholders. There is no like duty for a minority shareholder, which allows the shareholder to act in its own self-interest.

Procurement of Exit Strategy

The ability to exit from a minority investment is tenuous as the investor does not control the timing or form of the exit event. However, there are certain ways to help streamline the exit process in the investor's favor.

For example, the investor can cause its investment to become prohibitively expensive (i.e. an increased ownership stake over time).

Further, the investor can negotiate for a put right, which would allow the investor to cause the target to buy back the investor's equity upon the happening of certain circumstances (i.e. if the target has not been sold within a certain time period after investment).

Each method may cause the target to cash out the investor earlier than anticipated, whether through a sale or otherwise.

As mentioned above, the number of minority investments is likely to increase over the next year or so. When faced with such an opportunity, an investor should not immediately dismiss the idea.

If the investment is one that the investor elects to pursue, following the strategies laid out above will help it manage its way through the uncertainty of such an investment and provide it with the compass needed to navigate to a successful investment.

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