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Looking Past the Face of the Shiny Penny: Check the Fine Print of All Private Company Investments

Article By:

According to the financial press, private equity investors are holding huge sums waiting for the right private company in which to invest. In late March, CNBC reported that private equity firms have a staggering $1.5 trillion in cash on hand (more than double the amount from five years ago) and that they are actively seeking deals in the travel, entertainment and energy industries. https://www.cnbc.com/2020/03/25/private-equity-eyes-coronavirus-hit-industries-theyve-been-waiting.html In April, Vanity Fair stated that in each of the past four years, private equity managers have raised more then $500 billion for investment, and noted that from 2013 to 2018, more private equity deals took place than in any five year time frame in American history. https://www.vanityfair.com/news/2020/04/how-private-equity-is-winning-the-coronavirus-crisis

PE firms are not the only ones who are making investments in private companies. Angel investors and others who are stepping up to fund privately-held businesses, and there are many documented success stories of individual investors who have struck platinum with their private company investments. It is is also true, however, that a sizable number of fast growing private companies hit the rocks and burned through all or most of the funds that were invested in them.

The purpose of this blog post is not to help pick private company winners—that is a topic for others with the ability to discern which companies have the best ideas, management teams and the staying power to succeed on a long term basis. But picking a successful private company is only part of the story. A private company's success will not automatically make an investment in the business a success if the company's governance documents do not provide the the investor with a measure of protection on several important fronts. This blog post therefore focuses on the critical terms that an investor will want to secure in the company's governance documents before actually making a substantial investment in the company.

Secure an Exit Right – To Monetize the Investment

Of critical importance, if it is not paramount, is the investor's need to secure an exit right at the time of the investment. This is often referred to as a buy-sell agreement, and it ensures that the investor will not be required to indefinitely hold an investment in the company that is both illiquid and marketable. The company may preclude the investor from exercising a buyout right for some defined period, perhaps as long as 5-7 years. But the investor needs to ensure that a buyout right exists,

which provides assurance that at some future point, he/she will have the right to monetize his/her investment in the business.

We have written extensively on the essential terms that go into a buy-sell agreement, including how the value of the investor's ownership interest will be valued and these posts can be accessed here and
here. https://www.winsteadbusinessdivorce.com/2020/04/time-for-a-buy-sell-agreement-private-company-owners-may-finally-need-to-put-a-clear-partner-exit-plan-in-place/ and https://www.winsteadbusinessdivorce.com/2018/07/perfect-buy-sell-provision-unicorn-one-size-fits-every-company/

Require Unanimous Vote to Amend

Many company agreements (for LLCs) and bylaws (for corporations) provide for the agreement to be amended by a majority of the company's owners. That may not sound like a significant problem, but it actually puts the minority investor at great peril. When amendment of the company agreement or bylaws is permitted by a majority of the company's owners, 51% of the ownership group can effectively rewrite the agreement or bylaws in ways that greatly harm the minority investor. For example, the majority owners can adopt new provisions that: (i) give them the right to buyout the minority owner for below market value, (ii) dilute the ownership percentage of the investor and/or (iii) eliminate all profits distributions the minority owner had been receiving and which were a basis for the investment.

While the minority investor may argue that changes of this nature are so major that they breach the fiduciary duties of the majority owners as officers, directors or managers, that is not a claim that finds a strong foothold in Texas law. Instead, Texas law generally favors the rights of majority owners to amend their governance documents if that right is set forth in the company agreement or bylaws. Therefore, investors will want to make sure that the version of the LLC agreement or bylaws that exists at the time of their investment cannot be amended except by the unanimous agreement of all owners at least with respect to issues that impact the investor's fundamental rights and financial expectations.

Include Tag Along Rights

After a period of extended success in the business, the majority owners of the company may decide to sell, which will cause the investors to expect a liquidity event to take place in which they cash out of their investment. But majority owners may decide to sell their majority interest in the business to the new buyer rather than selling the entire company. This sale of the majority ownership interest would leave the investors on the sidelines with no way to participate in the transaction along with the majority owners.

Investors can protect themselves and ensure that they have the right to participate in any transaction with the majority owners on the same terms by including a "tag along" provision in the company agreement, the bylaws or in a separate shareholder or members agreement. This provision requires the majority owners to include all of the minority investors in any sale of their interest in the company and to permit investors to participate in the sale on the same terms.

Most majority owners will not object to providing investors with tag along provisions to provide them with this type of protection in the event of a sale. What they will require, however, is that the investors accept "drag along" rights in exchange. A drag along provision requires that in the event

of a sale of the company negotiated by the majority owners, the investor must agree to sell his/her interest to the new buyer on the same terms negotiated by the majority owners.

Avoid Phantom Income

The vast majority of private companies today are operated as pass through entities, which means that the companies pay no tax on their income/profits. Instead, the tax on profits is passed through to owners who must may their share of the tax on a proportionate basis depending on the percentage of their ownership interest in the company. Most governance documents provide the officers, directors and managers with full discretion as to whether to distribute profits generated by the company or whether to retain them for use in the business.

The problem for owners is that if the company's management decides to retain its profits to support the company's growth, the owners are nevertheless required to pay federal income taxes on the company's profits even when no distributions are made. This is what is known as "phantom income," because the owners have not received any actual income. The owners who receive phantom income will have to use their own personal funds to pay the taxes on income that the company generated, but declined to distribute to them.

To address this situation if it is a concern to investors, company agreements and bylaws (for S corporations) can require the company to make minimum tax distributions on an annual basis. These provisions will require the company, at a minimum, to make distributions to all owners in an amount sufficient to cover their estimated tax liability on the company's income. Management will retain discretion as to whether to distribute any other profits, but will have to distribute the funds necessary to cover the tax liability of their ownership group.

Conclusion

Given the difficulty of finding successful companies in which to invest, private company investors will want to ensure that their investment is structured for success. This requires a close review of the company's governance documents to confirm that they have secured exit rights, are not subject to any harmful amendments by the majority owners, have defined tag along rights in the event of a sale and will not be subject to phantom income and unexpected tax liability. There are other provisions in the company's governance documents that investors will want to discuss with their business counsel, as well, but addressing each of these critical provisions will position investors to share in the success achieved by the company.

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