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Beware of Risks Involved in Start-Up Company Investing: Avoid Red Flags When Making Private Company Investments

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The “Great Resignation” as it has been called reflects the large number of employees leaving the traditional workforce, and many of those departing employees are leaving hourly or salaried positions to start their own new businesses. The dramatic increase in start-up businesses has been documented by the Census Bureau, which reports that nearly 5.4 million applications were filed to begin businesses during 2021, the most of any year on record. In light of this remarkable employee migration leading to the formation of new companies, now is an appropriate time to look at the investment side from the perspective of potential investors in these startups or early-stage new businesses.

This post reviews some of the important red flags that investors should consider before making a minority (non-controlling) investment in a new or emerging growth, private company. Not every red flag should scuttle the proposed investment in a private business, but prudent investors will want to evaluate all red flags before becoming a minority partner in a private company. The issues that potential investors are wise to consider relate not only to potential problems regarding the operational plan for the new business but should include key provisions in the company’s governance documents, which the minority investor will be required to sign when making the new investment.

Avoid a Management Team Embarking on Its “First Rodeo”

Common sense suggests that the safer bet when investing in new businesses is to choose a management team with a track record of success with start-up businesses. A management team with little or no previous experience in launching a new business will have a steep learning curve. Another way to look at this is that an inexperienced management group doesn’t know what it doesn’t know, which means that the company’s leaders are more likely to make mistakes and miss opportunities that more veteran leaders would avoid or capitalize on at the right time.

If the management team is new, one way to mitigate this problem is for the majority owners to include senior leaders on the company’s board or on an advisory committee. These experienced board or committee members can then provide important input to company executives on a regular basis and help to mentor them to provide the benefit and wisdom of seasoned leadership. When inexperienced executives decline to surround themselves with more veteran leaders, however, investors may be in for a steep and bumpy ride with their start-up company.

Will the Minority Investor’s Stake in the Business Be Protected from Dilution?

Successful companies need capital to fund their growth, and the cash from the business typically falls short of meeting this need. As a result, it is likely that the company will continue to seek additional investment from new investors, and when these new investors join the company, the percentage of the original investor’s investment may be subject to dilution. Therefore, the investor in a start-up company may want to have some type of “dilution protection,” which can take a number of different forms.

One example of dilution protection is a provision providing that no matter what new investment is received by the company, the percentage ownership that is held by the original investor cannot fall below a certain minimum – this is a form of downside protection. Another option is to agree that the original investor’s ownership interest (in whole or in part) is converted into some type of preferred stock or interest, which gives the original investor preferred treatment that could be additional voting rights and/or the right to receive additional dividends of some amount. The point here is that the original investor’s ownership interest may be subject to dilution and the slice of the pie held by the investor may be reduced greatly if the investment agreement does not address this issue.

A Buy-Sell Agreement Is Critical for Minority Investors

In the absence of a buy-sell agreement (a contractual type of exit right), the minority investor in Texas typically has no contract or other right to require the majority owners to purchase the investor’s interest in the business at any price. Instead, the minority investor has to wait for some type of liquidity event to take place to obtain the value for his or her stake in the business. This could be a sale or merger of the company, a complete recapitalization of the business, or an initial public offering (IPO). If none of these things takes place, however ? even if the company is profitable and has a high value ? the minority investor may be stuck for years holding an illiquid, unmarketable investment with no means to monetize the substantial value of this holding.

A buy-sell agreement allows the minority investor to give the required notice to the company, and under the terms of the agreement, the company is required to purchase the investor’s interest. The buy-sell agreement will specify the timetable for completing the purchase, the procedure the parties will use to determine the value of the investor’s ownership interest, and the payment terms for purchasing the minority interest once the value has been determined.

The buy-sell agreement will also specify when the agreement can be triggered. For example, the agreement may provide that the minority investor cannot trigger the buy-sell for some period of years after making the investment. This is referred to as a “delayed trigger,” and it assures the majority owner that the minority investor cannot require the company to purchase his interest in the business for some extended period of time. In sum, the delayed trigger gives the majority owner more breathing room to run the company before having to worry about the investor demanding a buyout of his or her interest.

Limit the Right to Amend the Governance Documents

This last point may seem obscure, but it is vitally important. Potential investors will want to check the amendment provisions of the company agreement (for LLCs), the LP agreement (for limited partnerships) and the bylaws for C Corporations. Many company agreements, LP agreements and corporate bylaws permit these governance documents to be amended by a bare majority (51%) of the business owners. In this situation, the majority owner(s) can completely rewrite the operative rules of the company, including major changes such as revisions to the distribution policy, the addition of new partners and dilution of existing partners, and the procedure for removing partners from the business.

The amendment provision in corporate governance documents is often overlooked, but it can make an important difference to the rights of the minority investor once the investment has been made. Often the minority investor learns only after the fact that the majority owner is changing the way that the company operates and when majority owners make these types of changes, they are rarely done in a manner that provides a benefit to the minority investor.

Conclusion

The opportunity to invest in a start-up company presents a high-risk/high-reward scenario, and the major upside that exists with these investments can makes them seem very attractive. But, the potential investor should also beware of the substantial risks involved, and the foregoing points should therefore be included on the checklist the investor considers before going forward with the investment.

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