BJ NN Business Journal News Network

(/)

NINE LEGAL CONCEPTS THAT AFFECT YOUR NON-CONTROLLING (MINORITY) INVESTMENT IN A BUSINESS

By James J. Nicoll and John J. Sierotnik
Date: 6/15/2017 4:45 PM

Investors who make a non-controlling (minority) investment in a business must contend with a variety of legal issues as they negotiate the structure and terms of their investment.

Below are nine legal concepts with which every minority investor should be familiar.

1. Priority returns
Companies are often structured to provide preferred or priority returns that favor certain investors over other investors in the distribution of cash.

You should not assume that a purchase of a certain percentage of a business entitles you to the same percentage of the profits of the business or of the proceeds of a sale of the business.

If you invest in a corporation, you should inquire into the rights of any preferred stock.

If you invest in a limited partnership or limited liability company, you should inquire into the provisions of the limited-partnership agreement or operating agreement that govern allocations and distributions of cash to investors.

2. Transfer restrictions
Minority investors need to be mindful of legal and contractual restrictions on transferring their securities.

Federal and state securities laws place significant restrictions on the ability of an investor to transfer the securities of a privately-held company in which he or she has invested.

In addition, minority investors are frequently bound by contractual restrictions on transfer.

A company's governing documents may contain an outright prohibition on transfers to certain third parties (such as competitors of the company) or may require investors to obtain the consent of the company's board of directors (or equivalent governing body) prior to any transfer.

A company's governing documents may also contain a right of first refusal, which requires a minority investor that has received a bona-fide offer to purchase his or her securities from a third party to offer the company and/or other investors the right to purchase such securities prior to consummating a transfer of the securities to such third party.

3. Preemptive rights
A preemptive right provides an investor with the right, but not the obligation, to purchase securities in any future equity-capital raising transaction by the company on a pro-rata basis.

A preemptive right enables existing investors to maintain their percentage ownership in the company following an equity-capital raising transaction.

Minority investors often seek preemptive rights as a means to protect against dilution of their investment.

4. Tag-along rights
Like preemptive rights, tag-along rights are often sought by minority investors.

Tag-along rights provide an investor with the right, but not the obligation, to sell his or her pro-rata share of securities in connection with a sale of securities by other investors.

Minority investors are often concerned about the possibility that the majority investors will sell their securities in a transaction in which the minority investors are not afforded the opportunity to participate.

In this scenario, the majority investors would receive cash or something else of value for their securities while the minority investors would continue to hold their securities, perhaps indefinitely.

Tag-along rights address this concern by ensuring that the minority investors will have the right to participate on a pro-rata basis in any sale of securities by the majority investors.

5. Drag-along rights
A drag-along right requires a minority investor to participate in any extraordinary transaction (a merger or asset sale, for example) in which the majority investors sell their securities.

The purpose of a drag-along right is to ensure that a purchaser can acquire 100 percent of the equity interests of a company.

Drag-along rights are frequently included in the governing documents of a company for the benefit of the majority investors.

If you become a minority investor in a company, you should understand any applicable drag-along right and the obligations of minority investors pursuant thereto.

6. Fiduciary duties
Minority investors sometimes serve as officers or directors of the company in which they have made an investment.

If you become an officer or director of a company, you may owe fiduciary duties to the other investors.

There may also be other situations where you owe fiduciary duties to other investors, depending upon the particular facts and circumstances of your investment and role in the company.

Fiduciary duties are determined by the law of the state in which the company was formed.

They typically include a duty of good faith, a duty of care, and a duty of loyalty.

You should understand your applicable fiduciary duties prior to making an investment in a company.

7. Protective provisions
Minority investors frequently seek governance rights in the form of "protective provisions."

These provisions prohibit the company from taking certain significant actions without the consent of the minority investor.

Examples of actions that cannot be taken without the consent of the minority investor might include extraordinary transactions (for example: mergers and asset sales), the issuance of new securities or indebtedness, or the entry by the company into transactions with its officers, directors, or other investors.

Protective provisions can be particularly useful for a minority investor that does not have a representative serving on the company's board of directors (or equivalent governing body), but that nonetheless seeks a meaningful role in the governance of the company.

8. Amendments
Minority investors should carefully consider the extent to which the company's governing documents can be amended.

The rights that a minority investor negotiates for himself or herself are of no benefit if the majority investors can amend the company's governing documents to modify or eliminate those rights without the consent of such minority investor.

Care must be taken in drafting the provisions that govern the extent to which a company's governing documents may be amended.

Disputes concerning amendments to the rights of minority investors are a frequent source of litigation.

9. Registration rights
Registration rights provide minority investors with the right, but not the obligation, to register their securities under the Securities Act of 1933 following an initial public offering of a company.

Registration rights are useful to minority investors in companies that may go public because they

facilitate sales of securities once the company is a public company.

Registration rights come in the following two basic types, although minority investors may receive both types.

The first type is "demand" registration rights, which provide minority investors with the right to force the company to register their securities.

The second type is "piggyback" registration rights, which give minority investors the right to include their securities in any registration of securities initiated by the company.

If you are considering making a minority investment, you should understand each of these concepts and discuss them with an experienced transaction counsel.

James H. Nicoll and John J. Sierotnik are business attorneys at the Syracuse-based law firm Mackenzie Hughes LLP. Contact them at (315) 474-7571 or by email at jnicoll@mackenziehughes.com or jsierotnik@mackenziehughes.com.

(/news-email-alerts/) **Sign up for Daily Email News Updates (/news-email-alerts/)**

It takes more than policies to
KNOW YOU'RE COVERED.
» GET STARTED
NBT | INSURANCE AGENCY