



## Legal Structure of a Private Equity Investment

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## Key legal issues (1)

- Commercial terms of the transaction
  - Price
  - Number of shares
- Allocating risk
  - Warranties and indemnities
  - Liquidation and sale preference
  - Restrictive covenants for executives
- Gathering information
  - Due diligence reports
  - Warranties and indemnities

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## Key legal issues (2)

- Rights of the various parties
  - Information rights
  - Consent matters
  - Board structure and investor representation
- Control over share transfers
  - Pre-emption rights
  - Tag-along rights
  - Compulsory transfer provisions
  - Family trusts/tax planning
  - Early exits for management
  - Share incentives for second tier managers

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## Key legal issues (3)

- Exit strategy
  - Drag-along rights
  - Acquisition of control

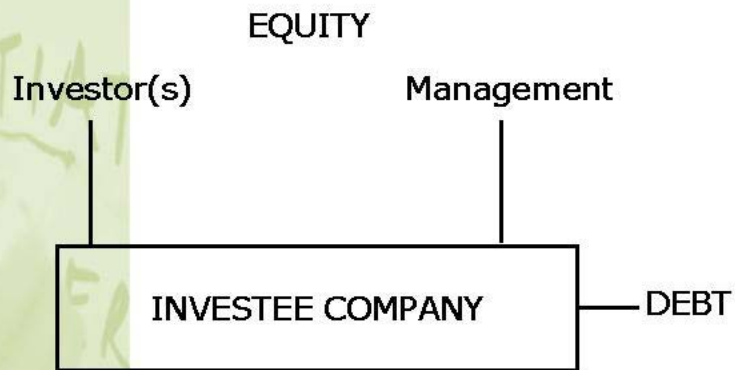
## Purpose of the legal process

- To clarify and document the legal issues
- To lay down a framework for the ongoing relationship

## Different types of transaction – form

- Early stage (start-up, seed round)
- Development/expansion
- Buyouts:
  - MBO
  - MBI
  - LBO

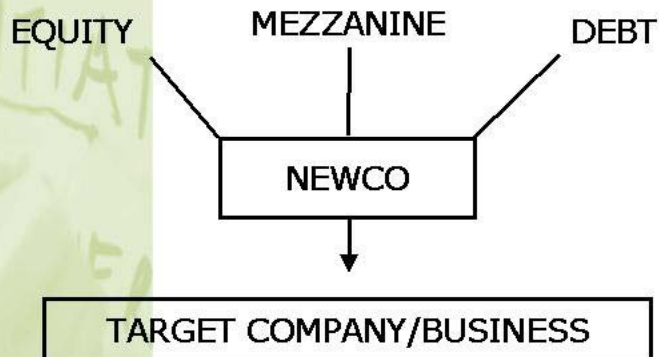
## Venture capital and development capital



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## MBO/MBI



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## Early stage

- **Characteristics**
  - Marriage
  - VC often has minority shareholding, therefore needs minority protection rights
  - Managers typically founders, therefore shares have accrued value
- **Parties**
  - Shareholders (managers, investor/s)
  - Investee company
  - Lenders

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## Later stage

- **Characteristics**
  - Two tier transaction (investment into NewCo: acquisition of target)
  - Marriage + divorce
  - Multi forms of finance – equity, debt, mezzanine
  - PE investors have majority interest, therefore voting control
  - Syndication?
- **Parties**
  - Investment – shareholders, NewCo, lenders
  - Acquisition – purchaser (NewCo), vendor

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## Financial instruments – structure

- **Early stage:**
  - Private equity
  - Management equity
  - Other sources (eg friends, family, business angels)
- **Later stage:**
  - Senior debt
  - Secondary (junior) debt (eg mezzanine or high yield)
  - Private equity
  - Some degree of management equity

## Principal legal documents

- **Investment:**
  - Offer letter
  - Articles of association
  - Investment agreement
  - Debt finance agreement
- **Acquisition:**
  - Company/business sale and purchase agreement

## Offer letter

- Also called:
  - Letter of intent
  - Memorandum of understanding
  - Term sheet
- Purpose:
  - Outline basis of negotiations
  - Give VC time for due diligence & to draw down funds
- Parties:
  - Management, investment vehicle and investors
- Not normally legally binding apart from:
  - Costs & exclusivity

## Articles of Association

- Constitutional document
- Defines:
  - Rights attaching to shares
  - Different classes of ordinary shares (if permitted)
  - Preference shares
  - Pre-emption rights
  - Permitted transfers
  - Leavers & joiners provisions
  - Forced sale rights
- Filed when a company is incorporated
- Can be changed later with the consent of the shareholders

## The investment agreement (1)

- Two parts:
  - Subscription part
  - Shareholders part
- Private document
- Hard to amend (needs unanimous consent)
- Parties:
  - VC
  - Management
  - Investee company (option)

## The investment agreement (2)

### Defines:

- Conditions precedent
- Subscription and completion
- Board of directors
- Accounts and financial/other information
- Investor's veto rights
- Insurance
- Dividend policy
- Exit objective
- Confidentiality
- Restrictive covenants
- Due diligence, warranties and disclosure
- Transfer of shares

## The acquisition agreement

- Debt finance agreements:
  - Loan terms
  - Covenants
- Service agreements for executives & key personnel

## Management buyouts

- Typically more complex and larger transactions
- Normally involve additional parties/ professional advisors)
- Additional documents typically include:
  - Further set of preliminary agreements
  - More detailed acquisition agreement/ancillary documents
  - Additional finance agreements

## Closing of the investment transaction

- VC and management subscribe their equity
- Debt providers formally make finance available to the investee company
- Key documents are produced
- In an MBO, the target business is acquired