

# From Lender to Shareholder: How to Make Your Equity Work Harder for You

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## Scenario:

You hold bank debt or bonds in a company that is being restructured, whether through a Chapter 11 bankruptcy reorganization or an out-of-court restructuring. As part of the restructuring, you (as well as the company's other creditors) are being asked to reduce (or extinguish entirely) the principal amount of debt you hold, but as an incentive to agree to the proposal, you are being offered equity securities in the newly restructured company. Alternatively, you are receiving a cash payout on your debt, and you are being offered the right to subscribe for new equity in the company in a rights offering. As part of either deal, you are presented with a suite of documents setting out your various rights with respect to the company and the other shareholders, almost always prepared by the lead lender's attorneys and similar to venture capital agreements with the lead lender taking the role of the lead investor.

## Question: If you will be a minority shareholder in the newly restructured company, what rights should you expect, and what can you get?

Some lenders will approach this type of scenario with the view "I'm getting x¢ on the dollar in new debt more than I paid, and the equity is just the icing on the cake." Others will make the (usually incorrect) assumption that they will be able to freely trade their new equity in the same way as the debt they previously held or the new debt they are receiving. The purpose of this article is to give lenders who are being offered minority shareholder positions in restructured

companies a checklist of rights to look for and of pitfalls to avoid when negotiating the terms of these equity documents. To maximize the value of a minority equity stake, a little work at the beginning can make a big difference.

This article has three parts. Section 1 discusses possible restrictions on liquidity that may limit your ability to get the most value out of your new equity. Section 2 outlines the basic protections and control rights that you should ask for in your equity documents as a minority shareholder. Section 3 highlights the key takeaways for lenders when negotiating equity documents.

As described more fully below, the keys to preserving the value of your minority equity position are liquidity and protection. Some of the considerations highlighted in this article require a modicum of "crystal ball" gazing since your preferences will depend on whether you believe you will likely be a seller or a buyer of the company's equity and whether you want to take a long term or a short term position in the company.<sup>1</sup>

## Section 1: Liquidity, Liquidity, Liquidity

The mantra of lenders taking minority equity positions in restructured companies should be liquidity, liquidity, liquidity. In contrast to a venture capital investor, whose business model expects an exit opportunity only through an IPO or acquisition by another company (often at least five years after investing), as a debt investor, you are used to being able to freely trade your debt instruments whenever you choose. Some companies and majority shareholders (and their lawyers) may tell you that you cannot expect your new equity in the

## Memorandum

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"To maximize the value of a minority equity stake, a little work at the beginning can make a big difference."

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<sup>1</sup> The equity you are offered will generally be either: (1) restricted securities received in a private placement, which are subject to limitations on resale pursuant to Rule 144; or (2) unrestricted securities received pursuant to a Chapter 11 bankruptcy under Section 1145 of the Bankruptcy Code. This article addresses concerns that recipients of private placement restricted securities should consider.

company to function in the same way. They may make the argument that restrictions on transfer are just part of taking an equity position and that all investors should be in for the long haul. In our opinion, this is not necessarily true, and lenders taking minority equity positions would be well advised not to accept unnecessary restrictions on transfer.

### *Restrictions on Liquidity*

Some restrictions on transfer, such as a Right of First Refusal (“ROFR”), a Right of First Offer (“ROFO”) or a Tag-Along Right, may severely reduce your equity’s liquidity and, as a result, reduce its value. Summarized below are the typical restrictions often included in equity documents and the reasons why these are problematic for minority shareholders:

- **Right of First Refusal.** Although a ROFR is commonly found in shareholder agreements, minority shareholders should be wary of its implications. A ROFR typically works like this: if you want to sell your equity, you must go out, find a potential third party buyer and negotiate the price and the other key terms of the deal, but you must also tell your potential third party buyer that you can only go ahead with the deal if none of the other existing shareholders swoop in and snatch it away. Understandably, potential buyers do not get excited at the prospect of negotiating a deal and undertaking due diligence on a company only to have the deal usurped by the existing shareholders (who very likely have better knowledge about the company than the potential buyer).
- **Right of First Offer.** Slightly less problematic to minority shareholders wanting to preserve liquidity is a ROFO, which differs from a ROFR in that you seek participation (or waiver) from the other shareholders *before* negotiating a deal with the potential third party buyer. Typically, a ROFO requires you (as the transferor) to give notice to the other shareholders of your intention to sell your shares to a third party buyer and to permit the other

shareholders to make a first offer on those shares. Generally, you can choose whether or not to accept an offer from one of the other shareholders, but if you don’t accept an offer from another shareholder, you may only sell to a third party buyer if the third party buyer offers you a higher share price and overall better terms than the best offer you received from the other shareholders. There is usually a time limitation (often 90 days) on completing the deal with the third party buyer, after which you have to give the other shareholders the right to make another offer. Given a choice, minority shareholders who expect to be sellers (rather than buyers) typically prefer a ROFO to a ROFR since it gives a third party buyer assurance that the deal it negotiates will not be snatched away.

- **Tag-Along Right.** While minority shareholders will want to have the right to tag-along on any sales by controlling shareholders (and should insist on this right if they are subject to being dragged along by controlling shareholders), they may not want sales of their own shares to be subject to a tag-along right in favor of other shareholders. A tag-along right gives all shareholders the right to sell a pro rata portion of their shares in any sale by a selling shareholder. The necessary time periods associated with the exercise of a tag-along delay and complicate sales by smaller minority shareholders and may require them to negotiate several different transactions to exit their positions.

### *Possible Compromises*

With any of the rights described above, you may consider proposing a carveout to a ROFR, ROFO or tag-along right so that sales of shares by small shareholders (typically, shareholders owning less than 5-10%, bearing in mind what your ownership percentage will be) or sales to any current investor in the company do not trigger ROFR, ROFO or tag-along rights, as having to comply with these provisions could unnecessarily interfere with the liquidity of minority

shareholders' equity positions. Make sure, however, that the triggering percentage threshold is tied to the percentage ownership of the shareholder and not the percentage of shares being sold, otherwise the carveout may permit a majority shareholder to exit its position in the company piecemeal, without giving the minority shareholders the opportunity to exercise their tag-along rights.

*Tax and Securities Law Restrictions on Transfer*

There are some restrictions on transfer that companies and majority holders may legitimately request to prevent certain adverse tax or legal consequences. Typically, these will fall into the following categories:

- **Tax Treatment.** For companies taxed as corporations, shareholders may be subject to restrictions on transfer to prevent limitations on the Company's use of net operating loss carry forwards. However, this restriction only needs to apply to shareholders with 5% or more of the company's outstanding equity. In addition, for entities taxed as partnerships (whether actual partnerships or, more often, limited liability companies), equityholders may be prevented from making any transfers that would cause (1) the entity to be treated as a publicly traded partnership or (2) the termination of the partnership for taxation purposes. While these are legitimate concerns, the corresponding transfer restrictions should be narrowly drawn for the specific intended purpose. For more detail on these concerns, you should contact your tax advisors.
- **Compliance with Securities Laws.** Other legitimate transfer restrictions are designed to ensure compliance with securities laws. First, new equity securities received by lenders may constitute "restricted securities" under Rule 144 of the Securities Act of 1933. Sales of restricted securities of public companies are limited under Rule 144 for six months following acquisition of those securities. However, private re-sales of those securities may be possible during that six month period if such re-

sales are in compliance with the securities laws. Second, the Securities Exchange Act of 1934 requires that if a class of the company's equity securities is held of record by 500 or more persons and the company has assets exceeding \$10 million, the company must register that class of securities with the SEC and thereafter comply with U.S. reporting requirements (e.g., Forms 10-Q, 10-K etc.). A company may legitimately require that transfers by shareholders not result in the company being forced to register with the S.E.C., which is expensive and time-consuming but, as with tax related transfer restrictions, this restriction should be narrowly drawn.

*Drag-Along Right*

This is a common provision in shareholder agreements, but the implications of a drag-along should be carefully considered by minority shareholders. A key modification that minority shareholders should focus on is making sure that the price offered to the dragged shareholders meets a minimum threshold (e.g., at least the liquidation preference of any preferred stock, at least the qualified IPO threshold, or – at the very least – not less than the price per share offered to the majority shareholder). Additionally, it is market standard that if you are subject to a drag-along, you have tag-along rights on any sales by the majority shareholder(s).

*Registration Rights*

As a minority shareholder, registration rights are a bonus but not essential. The key right to look for as a minority shareholder is to be able to "piggyback" on any registration initiated by a major stockholder or the company. Minority shareholders in a public company should also look for assurances that the company will stay up-to-date with its filing obligations so that the equity will become freely tradable to the public under Rule 144 at the earliest opportunity, usually six months after acquisition.

## Section 2: Protection and Control

As a minority shareholder, the minimum protection you should demand is pro rata treatment with the majority shareholder. If the equity documents specify thresholds for obtaining certain rights, make sure you will qualify. If the company is a Delaware corporation, you will be afforded certain basic protections under Delaware corporate law (mainly connected to the board members' fiduciary duties of care and loyalty), but if the company is a limited liability company, then these minimum protections may be substantially eroded (and often are) by provisions in the limited liability company agreement specifically disclaiming the duty of care and duty of loyalty. Summarized below are the specific areas you should focus on.

### *Approval Rights*

A key issue in any private company with a disparate group of shareholders will be approval rights. These rights are typically found in shareholder (or limited liability company) agreement or in the company's charter. Approval rights are often formulated as supermajority votes (e.g., 66 2/3% of the board or shareholders must approve certain decisions). You should make certain that this voting threshold cannot be controlled by the majority shareholder(s). While the list of supermajority approvals differs substantially among different companies, there are certain critical decisions you should consider including as supermajority votes:

- Affiliate Transactions. One serious risk for minority shareholders is that the controlling shareholder will cause the company to enter into "sweetheart" deals with that controlling shareholder (or its affiliates or other companies in which it has an interest). While background Delaware corporate law provides some protection against self-dealing, we would recommend that there be specific protections included in the documents. At a minimum, this should include requiring any transaction between the company and a shareholder or its affiliates to be approved by a majority of disinterested board

members or a majority of disinterested shareholders.

- Changes to the Charter or Other Organizational Documents. Although background law will give minority shareholders in corporations some protection against amendments to the company's charter, you should at least make sure that the specific rights that you have negotiated for cannot be amended without your consent (or the consent of the applicable threshold).

### *Information*

As a lender, you are accustomed to receiving regular financial updates about the company, which are vital for measuring the value of your debt. As an equityholder, your rights to information may be more restricted. Shareholder agreements often impose minimum holding requirements on the right to receive the most basic financial information about your investment. If the shareholder agreement is silent about receiving information, you should assume that you will get none. If an ownership threshold is applied to these rights, you should consider whether you meet it.

### *Board Composition*

Majority shareholders will often insist on a right to directly appoint board members. As a general rule of thumb, the number of board members that a majority shareholder gets to appoint should roughly correlate to the percentage of the company such shareholder controls. For example, on a board of five, a 40% shareholder should not have the right to appoint more than two directors. This right should always be adjusted downward if the majority shareholder's percentage ownership decreases (e.g., once the majority shareholder owns 20% of the company's shares, it should only be permitted to appoint one board member to a five member board). You should also be careful to ensure that the majority shareholder is not able to "double dip" on board appointments by having the right to directly appoint certain board members and then being able to

vote alongside the minority shareholders to elect other board members. You should also make sure that the majority shareholder does not have the right to approve committees of the board which are able to exercise the full powers of the board – if the company ends up with a split board, creating an executive committee could be a way for the majority shareholder to circumvent the terms of your carefully negotiated representation.

### *Preemptive Rights*

Most venture-backed companies offer preemptive rights that permit shareholders to maintain their respective percentage holdings. This is an important right to have if you are interested in staying invested in the company for the medium to long term, and is also essential to protect your position in the company from being diluted by issuances of “cheap stock.” Make sure that you don’t get tripped up by falling below any threshold percentage shareholding required for preemptive rights. Also make sure the documents do not contain a “pay to play” provision that says you will lose your preemptive rights going forward if you do not participate in every round.

### *Anti-dilution*

In addition to preemptive rights, if you are receiving convertible securities (e.g., preferred stock or warrants), you should insist on anti-dilution protection to protect the value of your securities. In short, anti-dilution protection provides that, if other shares of stock are issued for free (such as in a stock split) or at a lower price than the conversion price of your securities, the conversion ratio applicable to your convertible securities will be proportionately adjusted. Most venture-backed companies provide “weighted average” anti-dilution protection.<sup>2</sup> At the very minimum, you should insist on anti-dilution protection for stock splits and similar events.

### *Amendments Clause Protection*

Make sure that you are getting adequate protection against amendments to the rights you have carefully negotiated. Sometimes “boilerplate” amendments clauses permit majority shareholders to override minority protections by simply voting to amend the legal documents. Make sure that the amendments provisions in each document you sign contains an approval threshold that matches the protection you have bargained for.

### **Section 3 Take Aways**

Here are the key takeaways that we think all lenders being offered minority equity positions should focus on:

- A little bit of effort can go a long way. Focusing on the key rights outlined above and avoiding the mentality that equity is “icing on the cake” will go a long way to ensuring that you are getting the maximum value out of your equity holding. Don’t be swayed by majority shareholders who tell you that the equity terms they present to you are standard for equity deals. There are reasonable, market-accepted terms that you can insist upon that will ensure the equity you receive is as liquid as the debt you previously held and is treated fairly.
- Team up with other similarly situated lenders to make a bigger, squeakier wheel. Other minority shareholders may have similar concerns as you have, and you can use your combined bargaining power to get more of what you need. You should be careful, however, that when dealing with public companies or companies in certain regulated areas, you avoid being deemed to be a “group.” This can have adverse legal consequences. Talk to your lawyers before embarking on any coordinated campaign.
- Focus on key liquidity rights and key protections. Asking for these basic rights and protections sets up the longer term relationship between you and the majority shareholder. The other shareholders are now your partners in this company, and to

<sup>2</sup> In a nutshell, weighted average anti-dilution applies if new securities are being issued at a price per share lower than the price the existing investors paid for their convertible securities. If applicable, the conversion price for the existing securities is reduced to a price calculated by multiplying the existing conversion price by the following fraction:  $\frac{[\text{number of shares outstanding pre-deal}] + [\text{number of shares issuable for amount raised in deal if purchased at old conversion price}]}{[\text{number of shares outstanding pre-deal}] + [\text{number of shares issued in deal}]}$ .

maximize value for yourself (and everyone else)  
you need to set things up carefully from the start.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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