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Private Equity

An Examination of Exit Rights for Hedge Funds Making Non-Controlling Private Equity Investments

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A hedge fund contemplating a non-controlling private equity (PE) investment faces a set of concerns beyond those common to PE investments generally. These concerns boil down to a simple question: "How will we exit?" For investor liquidity and other reasons, the exit analysis should be front-of-mind for a hedge fund that is willing to make a PE investment without running the portfolio company show. The hedge fund should complete the analysis before committing capital.

This article explores a variety of exit-related rights that a non-control private equity investor (the Investor) may wish to obtain – or at least try to obtain – while negotiating and documenting its transaction. Not all of these concepts fit every situation. And sometimes the Investor simply won't have the leverage to get everything it wants. But familiarity with the contents of the exit-rights toolbox at least will allow the Investor to maximize its negotiating efforts, and to adjust its valuation based on a precise understanding of whatever exit rights are ultimately available.

Why Are Exit Rights Important for a Non-Control Investor?

An investment may be a non-control position due simply to its minority equity size. Or lack of control may reflect deal structure, such as where the Investor contributes a majority of the equity but an operating partner that originated the deal retains super-voting shares in a corporation or decision-making control as the general partner of a limited partnership or the manager of a limited liability company. Both situations present the same challenge to the Investor: can it effect a realization at full value at the time it considers right?

A key to answering that question is assessing how the control party's agenda may diverge from the Investor's needs. Exit timing, in particular, is a classic source of tension. For example, a financial investor with a non-control position might have realization deadlines driven by its fund documents, liquidity needs or other timing constraints to which the control party is indifferent. Some control parties, such as general partners or operating partners, may wish affirmatively to delay a realization in order to maximize their chances of earning a substantial carry. And other control parties, such as founding or family owners, really may not contemplate a future sale at all. Whatever the reason, it is quite possible that the Investor and the control party will have very different ideas as to when or whether the portfolio investment should be realized. If the Investor has failed to negotiate effective exit rights, it may find itself on the wrong side of the leverage equation and unable to extract value at a time of its choosing.

The Exit-Planning Toolbox

A number of contractual exit provisions have evolved to address the above concerns. Below we explore some of these customary provisions, with a view to analyzing their effectiveness in getting the Investor the liquidity it wants

Registration Rights

Among the most common exit rights for non-control investors are registration rights. These typically allow the Investor to sell its shares in a registered public offering, on a demand and/or piggyback basis. The principal weakness of registration rights is that the Investor usually cannot influence when they become available. They generally may be used only after the portfolio company has completed its initial public offering (IPO), which is a decision that typically rests with the control party. The second problem with registration rights is that when the Investor has a sizable equity position, an exit through registered resales may take too long. The relevant questions are how quickly the market can absorb a 25% or 35% ownership stake, and how thinly traded the stock is likely to be. Registration rights can work well where the company goes public and there is enough trading float and volume to readily absorb sales by minority shareholders, but this is not always the case.

If the Investor has an unusually strong negotiating position, it may seek registration rights entitling the Investor to force a portfolio company IPO. This right (like any that takes a realization decision out of the control party's hands) is difficult for a non-control investor to secure, but can be valuable if obtained. It will not affect whether the company is a good candidate to be taken public, nor whether the markets are ripe for an IPO and a solid aftermarket, but it does restore some balance in negotiating leverage between the Investor and the control party.

Overall, registration rights are useful and worth seeking, but in isolation they tend to be insufficient exit tools.

Tag-Along Rights

The other most common exit protection for a non-control investor is a tag-along right. This allows the Investor to exit side-by-side with the control party, at the same time, on the same terms and in amounts proportional to their respective shareholdings. Tag-along rights are useful but suffer from the same defect as registration rights – the control party dictates when they come into play. Also, the control party often wishes to have a threshold up to which it can sell its holdings without triggering the Investor's tag-along rights. The Investor should try to resist this type of threshold because it may provide the control party with enough interim liquidity to delay causing a company-wide realization event.

Drag-Along Rights

Drag-along rights are the obverse of the tag-along concept. They entitle the Investor, upon a sale of its shares to a third party, to require the control party to sell a pro rata portion of its own holdings to that third party on the same terms as the Investor. The ability to drag the control party may be valuable to the Investor if a third party buyer conditions its purchase on getting a larger stake in the portfolio company than the Investor itself holds. Drag-along rights classically accrue to the controlling party, but there are situations in which the Investor might negotiate successfully to obtain them. The most frequent of these situations is where the Investor has acquired its position in whole or in part from the control party (i.e., the control party has had a significant partial realization including a sale to the Investor), or where the Investor's position is a large minority stake.

As noted, it is typically the control party that negotiates for the right to drag the Investor along. If the Investor is willing to grant this right, the Investor should make sure that (i) the control party may not exercise the right below a minimum price per share and (ii) the minimum price increases over time. This protection is often overlooked and yet is critical because the interests of the parties may not be aligned. For example, it is often the case that the control party acquired its position well before the Investor did, and at a significantly lower company valuation – meaning a sale at a given price could be profitable to the control party but entail a loss for the Investor.

Put/Call Rights

Put/call rights generally are crafted so that either party, after a particular time period has elapsed, may sell its position to the other party or buy out the other party's position. The singular feature of these rights is their symmetry and they are thus most common where the parties' respective ownership stakes are close in size. Formal symmetry, however, may mask asymmetry in practice. Especially where the portfolio company's business is being managed by the control party as an operating partner, the Investor may have a much less realistic chance than the control party of successfully running the company as a sole owner. If the control party recognizes this reality, it may be tempted to set the buy-out at an artificially low price. The Investor sometimes can offset this disadvantage if it has access to purchase financing and the control party does not. In any event, in negotiating transaction terms, the Investor should consider the above factors and think about whether it is better off having or avoiding put/call rights.

Secondary Market Sales

A right to sell all or part of its equity interest to a third-party buyer allows the Investor to take exit matters into its own hands without the need for a company-wide realization event. It is important that any such secondary sale right be sufficiently free of impediments to make it practically useful. In particular, the transaction documents should make clear that the buyer (typically upon signing a joinder) steps into all the contractual rights that the Investor held; that the Investor is able to share nonpublic company information with a prospective buyer, subject to normal confidentiality arrangements; and that if board consent to the sale is required, it may not be withheld unreasonably.

It may be the case that the control party will agree to secondary sale rights only if they are accompanied by a right of first refusal (ROFR) or right of first offer (ROFO) exercisable by the control party. In general, a ROFO is preferable from the Investor's perspective, as the specter of a ROFR being exercised may chill the interest of potential third-party buyers.

Forced-Sale Rights

The exit rights we've discussed so far operate at the shareholder level. A right to force the sale of the company, by contrast, entails a disposition of the asset itself. Like a drag-along right, a forced-sale right is not often obtainable by a non-control investor, but in appropriate circumstances it is worth seeking. In particular, if the Investor has a large equity position, it may bargain for a forced-sale right that would take effect if the control party has failed to generate a satisfactory liquidity event by an agreed date.

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The forced-sale right is most frequently embodied as an agreement by the control party to cause the company to engage an investment banker and commence a sale process. But does it work? The principal weakness in the forced-sale right is that, like a forced IPO, it presupposes that the control party will play ball. Even if the transaction documents contain a forced-sale feature, the control party in practice can delay or block a sale through foot-dragging at the board, management and/or shareholder voting level. This means a forced-sale right delivers value to the Investor only if the control party is willing to cooperate at the time and in the circumstances of its exercise. That may be a big *if*.[1]

Control-Shift Rights

Control-shift provisions, if properly structured, are the most effective way to ensure an exit on terms acceptable to the Investor. These provisions generally state that if the control party has not engineered a satisfactory realization event by a certain date, the Investor can take control of the board (or the general partner in the context of a partnership) and the sale process. A control-shift provision thus eliminates the risk of majority non-cooperation that might undermine the utility of a forced-sale right. A non-controlling investor seeking to negotiate such a right should expect strong resistance from the control party.

Conclusion

An investor considering a non-control private equity investment should give careful thought to its preferred exit and the contractual rights that will optimize the likelihood of it occurring. The analysis includes not only an assessment of the likely form of the realization event, but also the motivations and priorities of the control party. Contractual exit rights are rarely a panacea – as we've seen, a non-cooperative control party can often retard if not derail a realization – but to the extent a non-control investment will represent a large percentage ownership stake, the Investor should consider adding robust exit rights to its list of "must have" deal terms. A non-controlling investor that decides to rely only on its future powers of persuasion with the control party to arrange an acceptable realization should be prepared for unpredictability and frustration.

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[1] A possible alternative to a forced-sale right is a right of the Investor to require a dividend recapitalization. This right effectively provides for a partial exit by means of a special dividend declared by the portfolio company (or, if applicable, its holding company). A non-leveraged dividend recapitalization is funded with cash already on the portfolio company's balance sheet; its advantage is that it should not increase the asset's risk profile (thus preserving upside potential), while enabling the Investor to reduce its downside exposure and achieve some liquidity. A leveraged dividend recapitalization is funded by new portfolio or holding company debt. The leveraged approach may make possible a dividend large enough to approach the full dollar value of the Investor's invested capital, thus substantially eliminating the Investor's downside risk. Of course, a leveraged recapitalization increases the risk profile of the portfolio company; and it hinges on the availability of the requisite financing and satisfaction of state law requirements regarding available surplus for the payment of dividends.