

Maintaining Control: following IPO, private equity & debt finance

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Mark Pinder

Head of International Corporate Group
Managing Partner, Abu Dhabi

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Control?

- ▼ Control comes in many forms:
 - ▼ voting control (50% plus v 30% plus)
 - ▼ board control (majority or influence)
 - ▼ positive (> 50% votes)
 - ▼ negative (blocking vote)
- ▼ Which is ideal?
 - ▼ that depends on the situation
 - ▼ it is different for a business that has 'gone public' (listed on a stock exchange) compared to one which remains private but has external investors



Public v private

- ▼ Private is a negotiated position
 - ▼ not controlled by regulation or law
- ▼ Control can easily be maintained

- ▼ Public is not a negotiated situation
 - ▼ it is affected by regulation and law
- ▼ Substantial shareholders may not be in 'control'
- ▼ Governance structures are designed to arrest control away from external influences and to create a level playing field
- ▼ All shareholders are created 'equal' – some may be more 'equal' than others ... but they will not have 'control' in the manner previously secured



IPO/listing

- ▼ 'control' is regulated by regulation, rules and persuasive guidelines
- ▼ Regulation/rules
 - ▼ EU directives govern the effect of a shareholder (acting alone or in concert with others) retaining or building a share stake above a certain %
 - ▼ in UK, more than 30% is crucial
 - ▼ mandatory cash bid, public disclosure etc.
- ▼ Guidelines
 - ▼ very effective
 - ▼ compliance is not required by law but ...
 - ▼ a statement of non-compliance is required in annual accounts and at time of IPO by the listing rules
 - ▼ laid down by the investor protection committees (ie largest institutional shareholding bodies) – they carry much influence
 - ▼ the '*Corporate Governance Code*' in UK – non-statutory
 - ▼ the *Sarbanes-Oxley Act* in US - statutory
 - ▼ designed to maintain independence of a listed company from external control and influence



Investor Guidelines – UK Corporate Governance Code

- ▼ Lays down guidelines for ‘good corporate governance’
- ▼ purpose –
 - ▼ ‘to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company’
 - ▼ sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders
- ▼ main principles –
 - ▼ **Board**: listed company headed by an effective Board - which should lead and control
 - ▼ **Balance**: board to be balanced between executive & non-executive directors (including independents) so that no individual or small group can dominate the board's decision making
 - ▼ majority to be independent from management and other business or other relationship
 - ▼ a senior independent non-executive to be sounding board for chairman and other directors
 - ▼ **Appointment** – should be formal & transparent process
 - ▼ nomination committee (having a majority of non-execs)
 - ▼ re-election - regular re-election of directors every 12 months for larger companies (FTSE 350) (3 years otherwise)
 - ▼ **Audit committee** – internal financial matters to be overseen by audit committee
 - ▼ comprises only non-executive directors
 - ▼ ensures transparent, effective, independent & objective auditing
 - ▼ **Fairness** - ensure all shareholder views are fairly represented



Relationship Agreement

- ▼ Financial sponsors may require a post-IPO controlling shareholder to enter into an agreement with the listed issuer
 - ▼ **Non-interference** - to ensure that controlling shareholder does not interfere with operations of listed issuer
 - ▼ all transactions between listed issuer and controller must be at arm's length on normal commercial terms (ie no private special deals)
 - ▼ all decisions must be taken independently of controller
 - ▼ **Fairness** - the business of the listed issuer is to run for benefit of ALL shareholders
 - ▼ **Compliance** with:
 - ▼ the stock exchange (listing) rules
 - ▼ the Corporate Governance Code (ie making it contractual)
 - ▼ **Director** - right to appoint a board director (dependent on % shares held)
 - ▼ **Protection** - agreement not to vary the by-laws/articles of the listed issuer
 - ▼ **Abuse** –
 - ▼ recognition of laws on insider dealing/market abuse/being in possession unpublished price sensitive information
 - ▼ compliance with internal share dealing code



IPO/listing - maintaining control?

- ▼ Post UK listing, a combination of the Corporate Governance Code and the law succeed in making it difficult for any controlling shareholder group to maintain sufficient influence which amounts to *control* (as was enjoyed pre-IPO)
- ▼ In reality, real influence is (of course) very difficult to restrict – whether or not it amounts to ‘control’, will be very subjective and difficult to assess in advance
- ▼ but be prepared – life after an IPO is very different!



Private equity investment

- ▼ To recap:
 - ▼ 'control' comes in many forms:
 - ▼ voting control (50% plus v 30% plus)
 - ▼ board control (majority or influence)
 - ▼ Positive (> 50% votes)
 - ▼ negative (blocking vote)
- ▼ In private investment situations, the level of control retained will be commensurate with the relative size of the external investors' investment
- ▼ In UK, there are certain key thresholds ...
 - ▼ 10% - power to convene extraordinary general meetings (EGMs)
 - ▼ 25% - power to block special resolutions
 - ▼ 50% - ability to pass ordinary resolutions (eg appoint Board)
 - ▼ 75% - ability to pass special resolutions (eg change articles)
- ▼ Let us look at 2 different types of investment:
 - ▼ controlled investments (typical in private equity)
 - ▼ minority investments (typical in venture capital)



Controlled investments

- ▼ An external investor will take a controlling stake
 - ▼ usually more than 50% of voting equity (often in economically preferred shares)
 - ▼ with right to appoint more than 50% of directors
 - ▼ day to day management will remain with executive directors ... but if the company goes into default or falls behind projections, the external investor will easily be able to assume full control:
- ▼ the rights are enshrined:
 - ▼ in the articles/by-laws
 - ▼ which cannot be changed without 75% shareholder resolution
 - ▼ and possibly a shareholders agreement
- ▼ as investor controls >50%, previous owners do not have control



Minority investments

- ▼ An external investor will take a minority stake (less than 50%, often less than 25%)
- ▼ It will not have control
 - ▼ day to day management will remain with former owners & executive directors ... but ...
 - ▼ if the company goes into default or falls behind projections, the external investor will easily be able to assume full control:
 - ▼ Its investment will be made through special shares (preference shares carrying economic rights, minority protection rights but no voting rights ... save if pre-agreed events of default occur):
 - ▼ its shares will automatically gain enhanced voting rights entitling it to be able to:
 - ▼ remove directors and change the Board
 - ▼ pass any shareholder resolution (75% vote) to change the constitution/articles/by-laws)
- ▼ As the external investor will then control >50%, previous owners will then have lost control



Bank debt

- ▼ Control comes through holding equity
- ▼ Bank control is determined by the terms of detailed lending agreements:
 - ▼ stay within bank tolerances (ie not in breach of financial or other banking agreement covenants), then ...
 - ▼ banks have no control – it stays with shareholders
- ▼ If there is a default, then ...
 - ▼ the lending agreement will give a bank special powers by either:
 - ▼ crystallising security
 - ▼ requiring early repayment of debt
 - ▼ both can rest control away from business owners



Insolvency

- ▼ If matters get really out of control ...
- ▼ Insolvency laws will provide mechanisms to enable creditors to take control to:
 - ▼ protect their financial exposure
 - ▼ organise asset realisation in ordered manner
- ▼ Control will move away from existing Board and shareholders to:
 - ▼ creditors &
 - ▼ those appointed in law (eg administrator/insolvency practitioner)



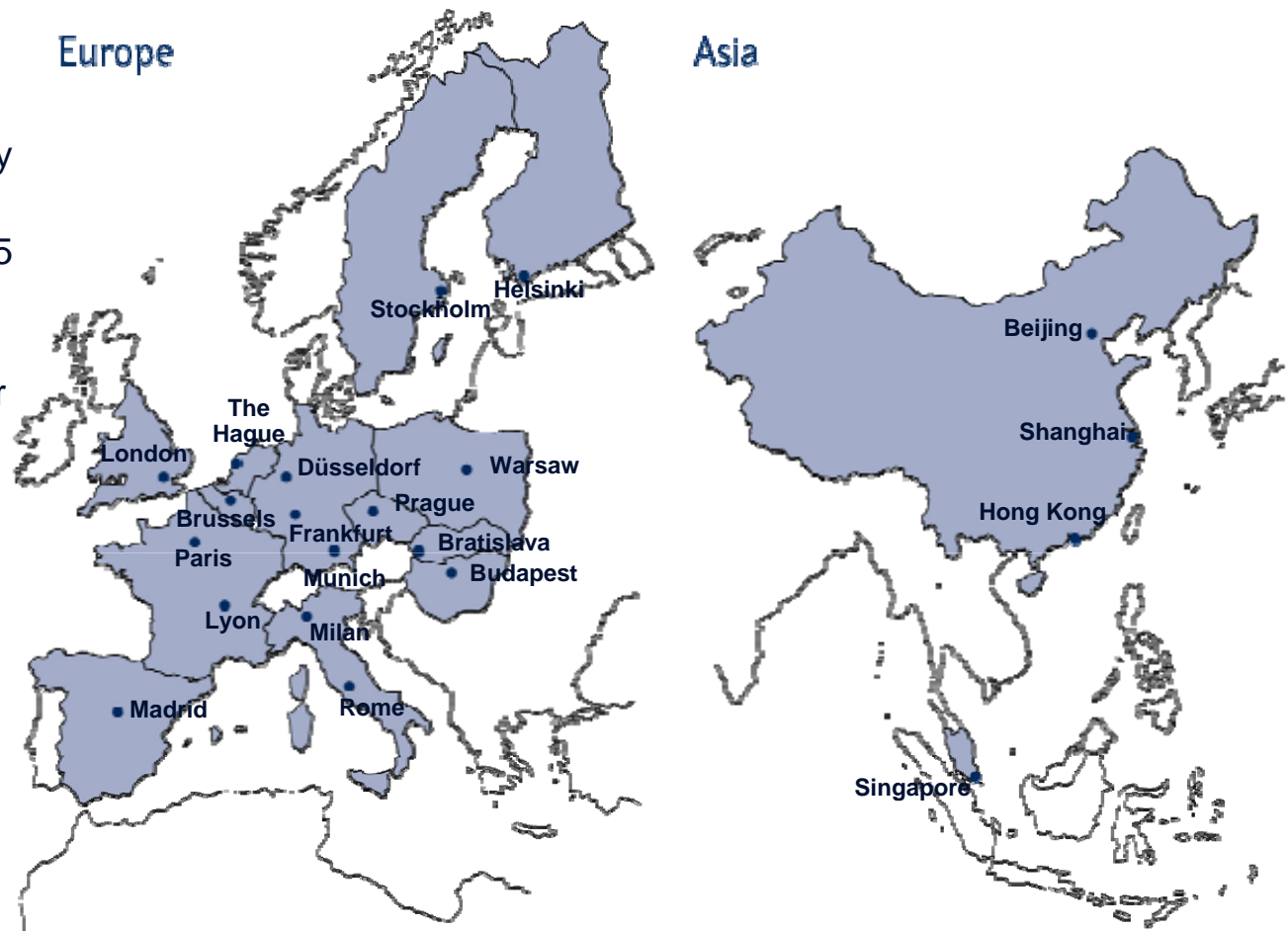
Recap

- ▼ IPO/listing –
 - ▼ control & influence is severely restricted through strong corporate governance
- ▼ private investment –
 - ▼ controlled investment – control moves to the investor
 - ▼ minority investment – control remains with business owners
- ▼ bank debt –
 - ▼ control remains with business owners unless event of default occurs – it then moves to the bank
- ▼ insolvent situation
 - ▼ if matters get completely out of control ... well you probably will not care at this point anyway



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