

# Growth Equity: Who is in Control?

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As I discussed in an earlier article [<http://www.fenwick.com/FenwickDocuments/2012-11-12-Growth-Equity.pdf>], growth equity (or growth capital) resides on the continuum of private equity investing at the intersection of venture capital and control buyouts. Growth capital is designed to facilitate the target company's accelerated growth through expanding operations, entering new markets, or consummating strategic acquisitions.

In addition to borrowing redemption rights from venture capital and debt financings, and preferred equity securities similar to those found across the private equity continuum, growth equity investors borrow protective provisions (operational control) commonly found in control buyouts and debt financings. This article provides a high-level overview of common protective provisions and their use in different forms of debt and equity capital, with a particular focus on protective provisions often found in minority growth equity investments – that is, operational control without cap table control.

## Protective Provisions Generally

Protective provisions are contractual covenants that govern what the issuer of a debt or equity security **must do** or **must not do** without the prior approval of the applicable securityholder(s). Put another way, a protective provision is an agreement by one party to take an action (in the case of an affirmative covenant) or refrain from taking an action (in the case of a negative covenant) unless the contract counterparty agrees that such action need not be taken (in the case of an affirmative covenant) or may be taken (in the case of a negative covenant).

A securityholder entitled to the benefit of a protective provision essentially has a “veto right” over actions governed by a negative covenant, or a demand right

over actions governed by an affirmative covenant. In this way, a securityholder entitled to the benefit of a protective provision can exercise operational control over the issuer without necessarily holding a majority of the company's voting securities.

## Protective Provisions in Control Buyouts

In a control buyout with a single private equity sponsor, the private equity sponsor holds a majority (and often significantly more) of the voting securities of the applicable portfolio company. From this equity position, the private equity sponsor holds the voting power necessary to elect a majority of the members of the portfolio company's board of directors. In turn, the board of directors manages the business and affairs of the portfolio company and elects its officers. In this scenario, the private equity sponsor has so-called “cap table control” of the portfolio company. With cap table control, the private equity sponsor has less need for the contractual control sought through protective provisions.

The situation becomes a bit more complex where a consortium of private equity sponsors collectively hold a controlling equity position, but no single sponsor holds a controlling equity position – a so-called “club deal”. In this scenario, the consortium of private equity sponsors will often agree to protective provisions with the portfolio company, the waiver of which require the consent of a majority or supermajority of the voting power held by the consortium members. This may eliminate the “veto right” of any single private equity sponsor, and effectively replace it with a veto right exercisable by some subset of the consortium members. The protective provisions commonly used in club deals are similar to the protective provisions used in minority growth equity investments – discussed below.

## Protective Provisions in Minority Growth Equity Investments

In a growth equity investment of the type described in my earlier article [<http://www.fenwick.com/FenwickDocuments/2012-11-12-Growth-Equity.pdf>], the investor typically acquires a minority of the voting securities of the applicable issuer – often as little as 10% of the outstanding capital stock. In this scenario, the growth equity investor does not have cap table control; rather, the holder(s) of the outstanding voting securities **not** held by the growth equity investor have sufficient voting power to elect a majority of the members of the issuer’s board of directors and thus control the operations of the issuer.

Many PE-oriented growth equity investors find this result untenable because they are putting capital at risk without statutory rights or voting control to direct how it is used. This leads many PE-oriented growth equity investors to insist on contractual control through protective provisions. As noted above, those provisions consist of affirmative covenants and negative covenants, often in the categories described below.

- **Affirmative Covenants** – That is, things the issuer agrees to do unless the preferred investor agrees that the action need not be taken – often include information delivery obligations (e.g., periodic financial statements, operating plan, etc.) and covenants with respect to the conduct of business, compliance with laws, maintenance of insurance, and maintenance of proper books and records.
- **Negative Covenants** – That is, things the issuer agrees **not** to do without the preferred investor’s consent – often include agreements not to make acquisitions, divestitures, or investments, make changes to its capital structure (e.g., issue senior preferred stock, pay dividends, or redeem stock), incur indebtedness or make any loans, engage in transactions with related parties, make significant operational changes, or declare bankruptcy.

## Protective Provisions in Debt Financings

In many ways, covenants commonly included in debt financing agreements are similar to the protective provisions outlined above. However, there are at least two notable distinctions between debt financing covenants and equity financing protective provisions. First, debt financing agreements commonly include robust financial covenants, such as a minimum fixed charge coverage ratio, a maximum total leverage ratio, a minimum interest coverage ratio, etc. Provisions of this type are less common (but certainly not nonexistent) in equity financing agreements. Second, debt financing agreements commonly include an affirmative “joinder covenant”, requiring that subsidiaries acquired or formed by the borrower after funding but prior to loan payoff be joined to the credit agreement, subject to the same restrictions and obligations as the initial credit parties, pledge their assets as collateral securing repayment of the loan, etc.

## Remedies

In a situation where the issuer fails to satisfy a protective provision, the growth equity investor’s remedies typically include remedies available “at law” (e.g., bringing a lawsuit alleging breach of contract and seeking to prove damages resulting from that breach), remedies available “in equity” (e.g., seeking an injunction enforcing an affirmative covenant or prohibiting violation of a negative covenant), and any contractual remedies included in the equity financing agreements. These remedies may include, among others, the right to compel the issuer to redeem the investor’s equity interest (i.e., a so-called “put right”), additional director election rights, and increased economic benefits associated with the applicable equity securities (e.g., increased preferred dividend rate). Such contractual remedies would typically last until the applicable breach is cured or the investor’s equity interest is redeemed.

Similarly, the continuing breach of a debt financing covenant – commonly known as an “event of default” – often triggers the lender’s right to accelerate the due date on all outstanding loan amounts (similar to the put right described above) and, to the extent the loan is not fully repaid, exercise its rights to foreclose on the loan’s collateral.

### **Key Takeaways**

Growth equity investing is not as well-known among target companies and their managers as traditional venture capital or control buyout investing. However, when properly sourced, diligenced, negotiated, and executed, growth capital may deliver higher returns for the investor when compared with traditional private equity investments. It can also be structured to provide greater downside protection. Similarly, by attracting competitively-priced capital from a sophisticated and seasoned partner, growth capital often represents an attractive financing source for companies poised to accelerate their revenue and profitability growth. It also gives existing equity holders the opportunity to participate in the future growth of the company.

This article represents only a high-level overview of certain characteristics of growth equity transactions. As is always the case in private equity investing or in considering partnering with a private equity investor, it is important to engage legal, tax, and other appropriate advisors early in the process. Engaging the proper advisors – and working collaboratively throughout the process – significantly increases the likelihood of a successful outcome.

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