MENA Private Equity:
Key Shareholders' Agreement Provisions

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1. Introduction

Most private equity investments in the Middle East and North Africa (MENA) region involve taking a significant stake in a business rather than a 100 percent acquisition. Such businesses are typically founder or family owned and seek additional capital or expertise, often with a view to a future initial public offering (IPO). In contrast, in a typical Western private equity model, the private equity firm (PE firm) acquires full control.

PE firms seek the maximum possible control over their portfolio companies, particularly over matters that affect value and the ability to exit at the highest possible price. However, in the MENA region, founding families typically have different, often inconsistent, interests and objectives. In addition, the legal regimes in many MENA jurisdictions are less flexible and less robust than in the West, creating obstacles to effective and efficient control. The terms of the shareholders' agreement entered into at acquisition, specifying who controls what and how, can have a serious impact on ultimate returns.

Whether the PE firm acquires a minority, an equal share or a majority of a business depends on the investment mandate of the PE firm and the opportunities it chooses to pursue. The principal terms of the resulting joint venture and shareholders' agreement hinge on these ownership distinctions. Early in the process, the parties should put as much effort as possible into agreeing to the terms of the shareholders' agreement, ideally agreeing to the main terms in a term sheet or letter of intent, alongside the terms of the share purchase agreement. Everyone can then have a clear understanding of the relationship between the shareholders and how the next phase in the company's growth will be governed.

This article presents an overview of some of the key issues that a MENA-based PE firm should consider relating to the negotiation of a definitive shareholders' agreement. In a separate but related article, we consider MENA acquisition structures and choice of law issues commonly faced.

2. Corporate Governance

(a) Overview. The principal question is who controls the board of the company. The number of directors each party can appoint usually correlates with its percentage shareholding. Naturally, where the shareholding is 50/50, equal representation at the board level is the norm. However, in such cases it is important to create a process for resolving a "deadlock." (See below for further analysis).

Control over the board can be exercised in a number of ways - through appointing a majority of the board members; having the right to appoint the chairman, who has a casting vote; or providing for weighted voting. In situations where it is important that no single party has control of the board, independent non-executive directors can be appointed (often by reference to the UK Combined Code's definition of independence). In such cases, the appointment of the independent director is keenly negotiated given that they may hold the balance of power.

Because the board of directors typically meets only once a month or ahead of significant events, the business plan for the company, sub-committees of the board, appointment of auditors and the appointment of the day-to-day senior management are key aspects to be considered when agreeing to corporate control structures. The ability to appoint (or veto) the CEO and CFO is of key importance. The ability to appoint the chairman is not usually key (unless he or she carries a casting vote), but can add prestige, and a founder may insist on this role.

(b) Reserved Matters. To provide protection for those holding a minority interest, a list of 'reserved matters' that requires a super majority of the board for approval or gives a veto right to one or more parties is typically negotiated. Alternatively, some or all of the reserved matters may be reserved to the shareholders for approval (and indeed some matters may require shareholder approval under applicable law).

A customary set of reserved matters includes:

- Extraordinary events (changes to constitutional documents, major acquisitions or disposals, mergers, recapitalisations or liquidation). Issuance of any share capital to new parties.
- Approval of and changes to annual budget and business plan. These will typically constitute pre-approved matters.

- Agreements, commitments, indebtedness (including guarantees) and capital expenditure outside of an approved budget, outside ordinary course of business and/or above an agreed amount. Licensing of key intellectual property to any third party.
- Loans and investments outside of an approved budget and/or outside ordinary course of business and/or above an agreed amount. Encumbering any key assets.
- Related party transactions/ conflicts of interest. This is particularly important to a PE firm where the other party has run the business for years and where the distinction between corporate and personal assets has historically been blurred.
- Hiring, firing and compensating senior management, including the CEO and the CFO. Approval of and changes to employee compensation and benefit plans. Grant of options to employees.
- Change of outside auditors. Change of accounting policies or year end. Declaration of dividend or other distribution.
- Commencement or settlement of material litigation.
- Decision to effect an exit (IPO, trade sale or leveraged recapitalization).

If there are more than two parties, there may be different tiers of reserved matters. Also, often only the key reserved matters are included in the letter of intent with reference to other 'customary reserved matters.' More detailed negotiations can then take place over the details in the definitive documents themselves once the business plans and budgets are more developed.

(c) Deadlock. A 'deadlock' is a catch-all term used to describe a scenario in which the shareholders cannot agree on an important issue. A deadlock is capable of arising either between 50/50 shareholders or when a minority shareholder has a right of veto on a reserved matter or other issue. Solutions for deadlock situations can be tailored for each set of specific facts; however, certain plans of action identified below can help ascertain the most appropriate solution.

A typical first step is for deadlock issues to be referred to a designated person or persons, such as any independent non-executive directors on the board, an external expert/arbitrator, or chairmen or CEOs of the parties to the shareholder's agreement. A key question is whether the resolution is mandatory or consensual.

Alternatively, one or both parties may have the right to effectively end the joint venture under one of three typical options:

- The deadlock issue serves as a trigger allowing the 'aggrieved' party to transfer its shares to a third party where such a transfer would otherwise commonly be prohibited by lock-up or other transfer restrictions (as discussed below). Variants include the aggrieved party requiring (through a put option) the other party to acquire its shares at fair market value (or a premium thereto) following a prescribed process.
- The deadlock triggers what is commonly referred to as the "shotgun" provision, whereby one party (the originator) offers to either (i) sell its shares to the other party or (ii) buy the other party's shares, in each case at the same price per share and on the same terms and conditions. The other party must then decide whether to buy or sell. The intention is for the originator to be reasonable in setting the sale price at which it may be forced to sell and sometimes this can be determined by an independent valuation. This may not always be appropriate if one party owns significantly more than the other, or one is financially much stronger than the other. A variant would be an auction process where each party bids for the other's shares until a price is set. (although this is potentially open ended).
- Deadlock gives rise to a right for either party to terminate the shareholders' agreement and bring a unilateral action for the liquidation or sale of the underlying business. This may be more appropriate for certain asset classes (e.g. real estate) or true joint ventures where strategic partners bring their own intellectual property or key employees to the venture, and it would not be appropriate for any other party to hold that asset.

In a private equity context, a permitted sale or put/call arrangement may be more appropriate. Also, a private-equity investor may be willing to be bought out after a certain period, provided certain IRRs (or other financial measures) are met. It may be that the other party is the founder and is not willing to be forced to sell.

(d) Committees and Delegated Authorities. The group into which the investment is made may previously have been run as a part of a wider group or even the personal company of the founder. Therefore, the existing internal controls may not be adequate, leading to a desire to implement best practices.

Best practices typically include an organised audit committee and, depending on the size and complexity of the organisation, a remuneration and nomination committee for senior management. This is an important safeguard for a PE firm, and it will seek control over, or at least a major participation on, the audit committee. The terms of reference of the committees are either determined by the board or agreed to at the outset with material changes constituting a reserved matter.

PE firms often have standardised delegated authority matrices across their portfolio companies that set out which matters need to be referred to and approved by the shareholders, the CEO, the board or particular committees. These should sit alongside any more formal changes to the constitutional documents of the company and its subsidiaries to ensure that the holding company remains in control.

(e) Directors' Fiduciary Duties. Shareholders typically owe no duties to other shareholders by reason of their shareholdings; conversely, each director on the board of directors is subject to a variety of fiduciary duties, including the duty to exercise his/her powers for the benefit of the joint-venture entity as a whole and not merely for the particular appointing shareholder.

There may be situations, such as in times of financial stress, where there is an unavoidable conflict between a director's fiduciary duties to the company or its creditors and the interests of the appointing shareholder. Solutions sometimes include transferring the power with respect to that matter from the directors to the shareholders, though frequently the director must either comply with his/her duties or resign.

3. Transfer of Shares

The PE firm will want to restrict the other shareholders from transferring their shares during the period of its investment to maintain all parties' focus on maximizing the company's value in that timeframe and also negotiate provisions which provide a clear exit route for the PE firm on a trade sale and do not adversely affect either value or process.

(a) Restrictions on Transfer. A typical shareholders' agreement restricts the transfer of shares to a third party (other than to affiliates). These restrictions tend to be finite in term and refer to a 'lock-up' period, after which transfers may be permitted (although often subject to a right of first offer or right of first approval discussed below).

If advisable under relevant company laws, many of the restrictions on transfer need to be embedded in the constitutional documents of the holding company. Special care should be taken with this issue because, in certain MENA jurisdictions, founders have been discovered to have entrenched rights that were not removed at the time of acquisition.

(b) Mandatory Transfers / Put and Call Rights. There may also be mandatory transfers in certain situations - often upon the death, bankruptcy/insolvency of the other party, upon a material breach and/or sometimes upon a change of control or upon other agreed triggering events.

In addition, the parties may negotiate certain rights where one party can require the other party to sell (a call right) or buy (a put right), which are triggered in defined circumstances and include a valuation mechanism. In the MENA region, it is unlikely that a founder or controlling family will allow themselves to be forced out of the company, and so these can be used as a tool by a PE firm to achieve an exit. In such circumstances, the key to any call right granted by a PE firm will be when it can be exercised (usually after three to five years) and at what price. While this can be based on fair-market value as established by a third party (plus an agreed premium), a PE firm may wish to instead base the price on a minimum required IRR on its investment or other financial measure.

(c) Right of First Refusal / Offer. Most shareholders' agreements grant each party a right of first refusal (ROFR) or a right of first offer (ROFO) over any interests that another party seeks to transfer. A ROFR requires the transferring party to have first received an offer from a *bona fide* third party, while a ROFO involves one party (the offeror) offering the shares to the other party at a set price. If that other party does not accept, the offeror is free to sell the shares for at least that price for a specified period of time.

These provisions are usually mutual and do not prove controversial. However, there are a number of factors to be considered, including the threshold issue of choosing between a ROFR or a ROFO. The answer will depend on who is most likely to be the seller. A ROFR requires that a third party is involved and leads to a longer process, the possibility of the third party requiring a break fee, and a possible unwillingness for third parties to submit a bid in the first place. A ROFO presents valuation issues, but leads to a clearer process and is preferred by private equity investors.

Often the ROFR/ROFO will require cash consideration, be subject to any tag-along rights (as discussed below) and must be exercised within a fixed period, otherwise no further ROFR/ROFO may be triggered by that party for a set period.

(d) Drag Along and Tag-Along Rights. A right for one party to sell its shares when the other sells to a third party (a tag-along right) or for that selling party to force the other to also sell (a drag-along right) is often included. In the private equity context, a mutual tag-along right will almost always be given as it does not force any party to sell and provides a mutual exit route. However, founder shareholders often resist drag-along rights because they refuse to allow themselves to be forced to sell. At the same time, the PE firm often seeks complete control over the exit transaction, and any impediment to its ability to deliver control or 100 percent of the shares in a trade sale is resisted.

Relevant considerations will be the parties' ownership levels (often the drag and tag rights are linked to a certain percentage of the company being sold). These rights will usually be subject to the ROFR/ROFO provisions.

4. Exit – Trade Sale / IPO

A PE firm will look for a clear and controllable path to exit its investment after a certain period of time, usually three to five years. The parties typically state a firm intention to seek an IPO or trade sale in the shareholders' agreement and provide for a detailed process to achieve that goal (such as an IPO 'roadmap'). In the current climate, a trade sale is the more likely exit route.

This process is often triggered at the election of the PE firm (subject to certain threshold requirements) following which the other parties are bound to proceed. In other cases, the shareholders' agreement may merely include an aspiration to seek an IPO or trade sale, without any formal process or obligations. In each case, it is important that a consensual process between the shareholders' and management be adopted. It is unlikely that a third party would want to acquire an interest in a dysfunctional company and, if it did, the valuation would be impacted. The agreed exit terms typically provide the basis for any consensus.

In relation to a trade sale, the principal relevant legal provisions are the share transfer rights identified in Section 3 above. The PE firm may also negotiate which of its control and other rights are capable of transfer to a third party buyer, which can have a material impact on valuation but are often difficult for the other shareholders to negotiate as it relates to an unknown third party. Further provisions may be negotiated obliging the parties, including the company and management, to cooperate to achieve the trade sale.

If the PE firm has the right to initiate the IPO process (after a set period of time), this is exercised by giving notice to the company and the other shareholders. For others to initiate the IPO process (possibly after a different period of time), the PE firm might require that it is on the basis that a predetermined minimum valuation is exceeded, perhaps calculated by reference to the PE firm's minimum required IRR for its investment.

Key factors to consider during an IPO process include:

(a) ***Investment Bank***. Once the company is required to commence the IPO process, it must select an investment bank to manage the process, assess viability and possibly underwrite the share offering. Often a list of acceptable investment banks is agreed in advance in the shareholders' agreement. The existing relationships of a shareholder may be a relevant disqualifying factor in determining the list or choices from the agreed list. However, a sophisticated PE firm is likely to have many relationships with leading international investment banks, so care should be taken to ensure any disqualification criteria are not too far reaching. Finally, consideration should also be given to the local investment banks if a MENA exchange is contemplated.

(b) ***Stock Exchange***. Mechanics for determining the relevant stock exchange(s) should be included in the shareholders' agreement. Again, this may be by reference to a predetermined list of acceptable exchanges and may take into account the advice of the relevant investment bank.

(c) ***Priority of Participation***. Each of the shareholders will typically enjoy participation rights in the IPO, although issues can arise in the event that the size of the public offering is limited or there is a 'cut-back' or minimum lock-up required by the underwriter or the applicable regulator or listing rules. If these restrictions are applied proportionally across the selling shareholders, it may leave a PE firm with a small tranche of its original ownership and not satisfy its desire for an immediate full exit. Given this situation, PE firms often insist on 'first-player' provisions setting out a pre-determined order of priority of participation, resulting in its shares being offered first in the IPO, with the other shareholders only having the right to participate after the PE firm included all of its shares in the IPO.

(d) ***Duty to Cooperate***. It is also important that each of the shareholders and the company undertakes in the shareholders' agreement to cooperate in good faith during any IPO process and to procure that others under their employ or control also cooperate.

(e) ***Costs and Expenses***. PE firms typically seek to ensure that the company pays all of the costs and expenses incurred in connection with the IPO process. The shareholders' agreement may set out in detail a non-exhaustive list of customary expenses that the company is expected to absorb.

The shareholders' agreement typically terminates upon the closing of an IPO.

5. Conclusions

The set of issues outlined in this article is by no means exhaustive. Shareholders' agreement negotiations put into play a broad and often complex set of interconnected issues between the negotiating parties, which are often particular to the parties and the circumstances.

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