The Deal Room Podcast

Episode 166 – Buying shares in a private company – the things to consider

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Transcript

Joanna: Hi, it's Joanna Oakey here and welcome back to The Deal Room podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal today you are in for a treat. Oh my listeners, we have onboard the fabulous Claire Bibby from our very own Aspect Legal to talk to you today about this next scintillating topic of buying shares in a private company. Claire, thank you so much for joining us today.

Claire: It is an absolute pleasure. I don't know how I'm going to live up to that introduction, but it's probably one of the best that I've ever had. So thank you, Joanna.

Joanna: My absolute pleasure. Okay, so maybe we kick this off by talking about why we're talking about this topic. Mostly in The Deal Room podcast, we talk about the acquisition of businesses, whether that's the businesses or the assets from an entity, or the shares as a whole within an entity. So today, we're actually talking about a bit of a different take on this, it's when if we're looking at buying into a private company, but not taking all of the shares, because it actually throws up a whole heap of different considerations. Some are the same and some are different. I guess that's why we're digging into this. What are the first things that come to mind for you Claire? When you think about this topic, when we have a client who comes in and says, Look, I'm looking at purchasing shares within a private company, but I'm not taking the whole box and dice.

Claire: Sure, well, I love doing deals that are buying and selling securities or shares in companies can either buy the business itself, or you can buy the entity that is the business and they can be shares, or they could be some sort of hybrid securities that can pretty much be anything. And that's what I love. I love the unusual nature of these sorts of deals, because as a lawyer, they really stretch me, now I know, our clients don't want that. But as a lawyer, this is where it's fun for me, how sad is that. So when we're going into the unlisted space, I think the biggest risk for folks when they're buying into this sort of environment is that they just don't have liquidity. So getting in can be fun. Getting out can be a pain and can be really difficult, as opposed to like buying and selling shares on the stock market where you just log your sale, and then somebody comes along and buys it, you just can't do that in the unlisted space.

Joanna: It's such a good point, like so often forgotten, isn't it? So you've got it. But what do you want to do if you decide that you want to exit at some point, because the reality is you're buying into a relationship, isn't it?

Claire: exactly, it's like buying a piece of paper. It's not like you're buying widgets, or bricks or a building. If you want to sell it, you've got to go and sell the dream of buying bits of paper to somebody else, which can be a real challenge.

Joanna: And so what are some of the techniques then that we think of in terms of when this comes up as an issue? How is it and we're not going to dive too deep into the answers here, but just like really high level, what some of the things that we think about in terms of controlling and dealing with that risk?

Claire: Sure. Well, the first thing we'd suggest, as anyone would expect, if they're listening to this podcast is get yourself a lawyer who knows what they're doing. Because buying and selling shares and making sure your clients interests are protected can be really tricky. And it is a specialist area. So don't use somebody who's never done this before. We also really suggest make sure you've got the lawyer and the accountant speaking to each other because your accountant if you've got one, and especially so if you've got a tax accountant or a tax specialist, is going to want to make sure that the financial outcomes that we as the lawyers get for you align with whatever their financial goals are, that they are trying to achieve for you. So the right hand of your advisors should really be speaking to the left hand of your advisor

Joanna: Such a good point because you know, you don't want your advisors sitting in a silo. Let them working together as a team with you as a client and talking together having a relationship together, and so often forgotten about so super glad you mentioned it,

Claire: I get the accountants, I build a relationship with accountants and, you know, they may initially be dragged along kicking and screaming, but by the end of the deal, they've got the result that they wanted. I haven't created any problems for them and similarly, they haven't created any problems for me as the lawyer so it's like a marriage made in heaven. Accountant and lawyers.

Joanna: I'm with you.

Claire: We love our accounting partners.

Joanna: I guess the next part here and perhaps I'm moving in the wrong order here because we sort of answering some of the issues as they come up, rather than perhaps leaving it to the end but just the one thing I want to throw in here is the importance of understanding things like your shareholders agreements in relation to, you know how it is that you might be able to build out this path for you for exits into the future needed. But that note won't necessarily help with the issues of the lack of liquidity. Yeah, but I guess we've talked about that. So let's move on what else sticks out to you as something that is a relevant consideration?

Claire: Well, let's leave aside the issue of hybrid securities for today. Because that's just way more complicated. So I won't talk about convertible notes or anything like that. I'll just talk about shares today, if I may. And I think the big first understanding that our clients need to know is are they buying on what's called ordinary shares? Or are they buying preference shares? Because that's really important when it comes to when distributions paid out? And also, if the worst happens, and the business ends up going under? Are you going to be the last man standing? Or are you going to have some preference to get paid out before other people? So you want to know, what is it? What am I buying? Is it preference shares or ordinary shares. Now if you are a shareholder, you can have a say on anything. To have your say, you've got to have the right to vote. So what are you buying? You're buying shares that are voting shares? Or are you buying shares that have no voting rights whatsoever? Because if you've got no voting rights whatsoever, my friend, no one is going to be listening to you.

Joanna: That is such an important point, because I've dealt with lots of transactions before where clients at the beginning approach the relationship, you know, they're all loved up at the beginning right?

Claire: Oh yeah. We are friends and family. We love each other.

Joanna: They think they're all going to get on, and..

Claire: Then money comes in.

Joanna: Yeah and then money comes in, you know, or the reality of the operation of this business over a period of time, when suddenly the differences become really apparent. And so whilst, you know, we might say, at the beginning that it's really important that you have the ability to have some impact on the decisions that have been made for the organization, when clients say, Well, you know, what, we really have a clear understanding and event, they're not going to give me that, yeah, red flags go up.

Joanna: I'll assign to a client yesterday, you're getting in bed with another person, effectively, it's like a marriage and everything's great at the beginning, it's a honeymoon period, you love each other, then comes the separation, and then comes the divorce. And then that's when you've got lawyers at 20 paces, and things can get a bit aggro. And so having talked about this stuff, at the beginning, having understood what your rights are, is really so critical. So walk into, I just say to clients walk into the relationship with your eyes wide open, so you know, what it is that you're buying, and you know, what obligations you have, if you've got any, and you know what rights you have because keep in mind, you're buying a bit of paper, you're not buying the bricks and the mortar. Often the timing within which you're buying into a company is very important, because you want to know what's already set up in the business. If you're not the founder, and quite often, you know, our clients may not be the founders, there's often things that you can find in the shareholders agreement that says, you know, the founder has these superpowers and the founder has to be the one that says yes to everything. If you've got those sorts of clauses in there, which is awesome if you're the founder, but for our clients, if there's a founder that has final say on everything, which they might agree to, but it might mean effectively at the end of the day, you've got no power? Absolutely none.

Joanna: Sometimes I find clients come in thinking that they'll resolve this by having an initial appointment as a director, but that's not necessarily the answer. And in fact, that can carry risk. So it's important to understand that, and we'll talk about that in a moment in relation to, I guess, some of the controls and due diligence that needs to be in place. But the question of the directorship is interesting, but I guess it's also important for people to understand which often they don't. Just because you're a director at one point in time doesn't mean you have an ongoing right to that unless it's built into some documentation like for example, shareholders agreement, because quite often it's the case that if you don't hold enough of a voting majority, you might just be able to be removed. That can be misunderstood.

Claire: Yep, totally. That's one of the early questions I ask clients actually is are you expecting to be a director and what comes with a directorship, as you touched on Jo is you've got obligations. These are obligations that are embedded in the Corporations Act, which in itself is about three inches thick and printed in a very small font and on very thin paper. So whilst I may have read all of it, not all of it, like, they read none of it or I assume they have anyway. They don't know what their obligations are. But you know what, Jo, if you're not a director, and if you don't have any protections in your shareholders agreement that says you're entitled to get financials or budgets, or business plans or anything like that, you may end up my friends with jack, you might not get any information. So you hand over your 50 grand, 100 grand, whatever it is that you're investing. You would want to know that someday or at some regular period of time, somebody's going to come back and tell you what's happening with your money. Yeah, that's when your lawyer is going to protect you and ensure that all documents that are set up at the very beginning, say really clearly, whether you're entitled to a directorship, whether you're entitled to financials, whether you're entitled to any information, don't just assume that there's going to be an annual general meeting, and as a shareholder, you're going to get information because you know, you may not, then unless it's in the paperwork, you may have no entitlement to anything.

Joanna: That's such a good point. Boom, awesome point there.

Claire: Yeah, the boom bit can be a bit problematic. I mean talking about booms, you want to have a lawyer that knows stuff like a drag along right, a tag along right, pre emptive rights, like all of these words, our clients may have heard of, but they may not know what they mean whereas, you know, people like you and I, Jo, we live in breed this sort of stuff, we get what it means. And we're here to help the clients and let them understand how important it is, if you've got these clauses, what they mean and if you don't have those clauses, what it means as well, because sometimes it's good to have clauses depending on which side of the ledger you're on, whether you're a big shareholder or a little shareholder.

Joanna: And I guess, going on a bit of a tangent here, because that's what I just love to do. It brings up a really good point about the importance of you being brought along the ride with your lawyers as well. You leaving this transaction feeling like you've got a good handle now on your actions are there for you, because it's an often discussed thing that I've heard people talking about in the interactions with lawyers, that they leave these deals, sometimes not fully understanding at the end of the day, what all of these elements mean. And I think that, you know, it's one thing we really focus on, but I think it's really important, just to make that clear, for anyone who is looking at this space, make sure you're dealing with someone that will explain it to you in a way you understand.

Claire: Oh, yeah, totally. If you ever Google the personality of a lawyer, or what people think about us, and you get past all the really bad jokes. Because there are an awful lot of really bad jokes about lawyers. We are there to help. But people often come to us when they're, you know, at a crisis point. Yeah. Or they're about to spend a hell of a lot of money on something. And we need to be able to speak to them and explain stuff in their language so that they understand. And if you're left, walking away from your lawyer thinking, what the hell did they just say to me, then your lawyer hasn't done a very good job because we need to explain it to you in a way that you understand. So you don't have to speak our language, but we have to speak yours, we have to understand your business. We have to understand where you want to go, and what we can do to help you get there.

Joanna: Yeah, love it. Okay, well, I can't help but go on tangents. But how about I bring us back? So we've talked about liquidity at exit, we've talked about understanding the type of shares that you will be acquiring, we've talked about whether or not you're going to have a say. So what else should we be looking at or thinking about here?

Claire: Well, one really important thing is if you buy shares, what have you been allowed to do in the future when it comes to competitors? So let's say I bought into a chicken shop. And that was what the business of the company is that I bought shares of, it's a chicken shop. You want to read the agreement and see if there any restrictions on me now as a shareholder? Am I prohibited from buying shares in competing chicken shops? Or am I restricted from ever working in a chicken shop, because if you're Colonel Sanders, you're really going to want to go and work in another chicken shop. So you want to know what sort of restrictions and these this sort of stuff is usually in small print at the back of the agreement, and you're probably a bit tired by then because you've got to page 50. And you're not wanting to read about all this stuff. That's where our says your lawyers will come in and read and tell you what the restrictions are. Especially if you're investing in a business that is in the same industry, that you're aleady in. You don't want to find that all of a sudden your hands are tied, and you can either invest in other similar businesses, or you can't work in similar industries? And, you know, let's take it one step further. What if there's a long tail? What if it says, once you sell your shares, you actually still can't go back into this business? Well, this industry for two years, you know, you expect to see confidentiality clauses, you expect to be told that you're going to find out stuff about our company, and you're not allowed to tell anybody. But are you expecting to find that if john down the road opens a chicken shop and comes to you with a great opportunity to invest? And you can't, because you invested in peach chicken shop? You know, that's a nasty surprise. And you don't want a nasty surprise.

Joanna: It's on the flip side, as well, sometimes is this consideration of whether or not you might, or you should be expecting to see some sort of restraints from the other people perhaps, and quite often the founders of the organization that you're buying into, because certainly, you know, there can be issues if you think you're buying into an organization. And then you find then that the people who are involved are involved in some sort of competing organization. There's two sort of sides to this, aren't they there's a lot of things to think about.

Claire: Well, you're often not just investing, as I said, in the piece of paper, you're investing in that person. That person that you've built the relationship with, and if they're awesome at their business, and that's what induced you to give them your money. You want to make sure that they're not going to bail on you in six months time. And then you'd be left with a piece of paper, but your colleague has disappeared off into the future. One of the really important things to understand when you're buying into a company, depending on what stage of development it's at, is that there's a really good chance that you're not going to get any returns for a while. So if you're going to buy into a private company, especially an unlisted company, expect it to be like a marriage, it's going to be a long term relationship. And hopefully, like a marriage, it'll be a long time until you end and leave but there may come a day when you want to end the relationship and leave and you want to make sure that you got those rights in the papers.

Joanna: Yeah, absolutely. Okay. So then let's talk about some of the ways that we can protect ourselves when looking at acquiring shares in existing companies. So we've talked about the sorts of issues we should be considering, I think we should talk a little bit about due diligence, to what extent we need to be considering due diligence, because in many instances, I find that when, you know, sometimes it's a reflection of the sum invested. But I find this idea of due diligence in some people's minds applies only to when you're acquiring a whole entity, rather than shares within an entity. But really due diligence is just as important, and sometimes more so.

Claire: Yeah and it's bigger. When you buy shares, there's more due diligence. And this is where it might sound a bit counterintuitive, given what I said at the beginning, I said you're just buying a piece of paper. But when it comes to DD, you need to do due diligence, not only on what that piece of paper means but you also got to do due diligence on the business. So you've got to imagine I am buying the chicken shop. So I've got to go and have a look at the leases, I've got to go and have a look at the staff and how much they're being paid. That data makes up the money that comes in and the money that goes out of the company, which is therefore the profit you're going to get. So buying a company is still the same due diligence, but more so because what you do when you buy a company is we talk about things like sexually transmitted debt, let's go the STDs when you buy a company you buy tax. So this company hasn't paid its tax three years ago, and ATO smack a tax audit down on the company. My friends, you are going to have to have that that tax audit paid from your money today. You can't say to the company, why the company three years ago, too bad to sad, my friend. You also have to dig into the paperwork, you've got to look into the tax history of the company. You got to look into the financials, you've got to look at what money is coming in and what money is coming out. And depending on the size of the purchase. This is when your lawyers and your accountants and particularly your tax accountants will start to get really into the nitty gritty of reading the words and will ask for what's called warranties and indemnities from the seller. So promises like we have paid our tax. There are no tax audits, we have done all of our badge returns. And you as the clients, you're probably not thinking about all that stuff. But we as your lawyers and your accountants, this is not our first rodeo my friends, we've done this before. We've got the clauses and we will ask for this sort of stuff to protect you. Due Diligence is important. Doesn't matter if you buy bricks and mortar or pieces of paper, you've got to do your due diligence.

Joanna: Yeah, absolutely. And I love your discussion about the warranties. Hey, we're lawyers, of course, we love discussions. I can hear what all of you were saying out there. You listeners, you're on to us. I guess what I wanted to point out there was it's also the importance of having a commercial head on these areas, and understanding what's usual and what's really required in the situation. Because sometimes we do have this situation where we deal with lawyers on the other side, who really just don't get the commercial imperatives. So it's about having them there. But it's also about understanding what's commercially realistic. Yeah.

Claire: Well, we've done as I said, not our first rodeo, we've done enough of these deals that we know what is market standard and what isn't. And when you're talking about, you know, giving warranties and indemnities, but there's a minimum percentage of the let's attach it to the gross profit for the last three years. And then you know, the numbers and the words just all start to merge in and the clients eyes glaze over. And they think, how is this all about? And we can say, you know, that's a really fair cause this is market standard, or this dude is having a lender view, and this is not market standard. And he wants warranties that go for 10 years telling you tell him, he's dreaming. Let's bring it back to three years, which is market standard and then with knowledge and the training that we've got, we can tell the clients and we can tell the other side if we have to, this is BS, my friend. This is not market standard.

Joanna: Yeah. Love it. Love it. Love it. Okay, so we've talked here about the sale agreement itself and warranties in the indemnities that sit in there to protect you and your investment. And we talk about it as sale agreement. But it might actually be a subscription agreement. I think one of the mistakes here is quite often investors don't necessarily think about or even properly understand the difference between an existing holder selling their shares versus the company issuing shares. So that's something to be aware of. Yeah. So we've talked about that agreement, whether it's a sale or subscription agreement, we talked about due diligence, and we touched on a shareholders agreements. And I think we should come back and talk about shareholders agreements as well in greater detail. But suffice to say, shareholders agreements are part of the body of documents and agreements that really should what must be there, Claire: The shareholders agreement is your Bible. That's what that's what I say to clients. Like, if you haven't got one, and you believe in God, then you're missing the central piece of that relationship. So often, because people go and buy shelf companies, Jo, as you know, and they might get a constitution but they never get a shareholders agreement. And any lawyer worth waiting salt, even let alone have a clause that says the shareholder agreement overrides anything that it conflicts with when it comes to the Constitution. Now, if you've got an agreement that says it overrides your constitution and you haven't even read it, then my friends you could be in for a headache. There's a lot of paperwork. There's stuff like options. And I talked about hybrid securities and call options and put options and loads of different stuff and ways that these deals can be transacted. And that's when it's really great to have a broker involved because a broker is going to tell you what the transaction looks like. Then they come work with us to ensure that we can make your dream a reality. At least hopefully, we can through the legal documents.

Joanna: Absolutely. Love it Claire. Is there anything else you think we've missed out for our listeners here? I guess we've we've covered a lot today. And I guess my last thought on all of this is that it might sound very complicated to someone listening in, we've gone through a lot of areas, but ultimately, at the end of the day, it's about finding people who understand this area properly to lead you through it because you don't have to lead yourself through it. You just need to ensure you've got the right people to lead you through it. So what's your lasting thoughts on at all Claire?

Claire: Well, you know, my parting thoughts to the listeners are at the end of the day, get yourself a good lawyer, get yourself a good accountant and get them to talk to each other because our job is to protect you. You know if you're buying a I'm doing going to do the chicken shop example again. If you're buying a chicken shop, you know you need to know your secret herbs and spices and all of that sort of stuff. We as your lawyers don't need to know the secret herbs and spices but we do need to know at a high level what your industry is but at a minute level, we need to know how to do these deals so as to protect you. So that if things go great, your paperwork works for you but on the other side, if things go bad, we want your paperwork to protect you and a good lawyer, good accountant will work together to achieve that outcome for you.

Joanna: Absolutely love it. I just want to say a huge thank you for coming on the show.

Claire: My pleasure Jo, I mean who doesn't love talking about buying shares in an unlisted company?

Joanna: I know right? Yes! Finally people are with me. Hahaha Brilliant.

Joanna: And that's it for this episode on buying shares in a private company. So if you'd like more information about this topic, just head over to our website at www.thedealroompodcast.com where you will be able to download a transcript of this podcast episode if you're the kind of person who just likes to read this all in great detail you'll also find details of how to contact Claire or any of our other legal Eagles at Aspect Legal if you or your clients would like to discuss any legal aspects of business sales or acquisitions or buying shares in a private company. We've got a range of services to help guide businesses through the sale or acquisition process and finally if you enjoyed what you heard today, then please pop over to your favorite podcast player and leave us a review and don't forget to hit that subscribe button so we are delivered to your podcast player every week as we release. Well thanks again for listening in. You've been listening to Joanna Oakey and The Deal Room podcast, a podcast proudly brought to you by our commercial legal practice Aspect Legal. See you next time.