

Insights

PRIVATE EQUITY INVESTMENT: FOUNDER BRIEFING NOTE

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A “trade” sale and an investment by, or exit to, private equity are not the same thing. Further, PE investments take different forms: majority buyouts (where PE takes control and Founder retains a minority stake) and minority investments (Founder keeps control, PE takes a minority position). The deal terms, post-investment dynamic and respective positions of the parties can differ significantly.

This note reflects our experience advising across PE transactions for sponsors, management teams, and Founders alike. It is intended to manage Founders' expectations and help them understand what to expect in both majority and minority scenarios, so that issues are identified early and the transaction proceeds efficiently for all parties. It offers guidance on customary protections, while recognising the investment, stewardship, and expertise of sophisticated PE investors, who repeatedly build businesses, can add value for all stakeholders.

1. You Are Not Just Selling: You Are Entering a Partnership

The most important mindset shift: unlike a trade sale, PE investors seek to back Management and Founders who wish to stay. In a majority buyout, the Founder becomes a minority shareholder in a business previously owned outright. In a minority investment, the Founder retains control but takes on an institutional investor with extensive contractual rights, structured reporting expectations, and a clear path to liquidity. These are standard features of institutional investment and reflect the investor's need to protect and monitor its capital and to be able to return capital to its limited capital partner investors. The PE firm's return on investment is directly linked to the performance of the business under the Founder's management. The parties' interests are aligned, but the dynamics of that alignment need to be clearly understood and documented.

In a majority deal, the investor will put in place structured governance arrangements and will have a significant role in determining the timing and form of the next exit. In a minority deal, the Founder retains operational control, but the investor will secure contractual protections (Section 4 below).

The Founder is not just negotiating a price. The Founder is negotiating an ongoing relationship.

2. Understanding the Consideration Structure

In a PE deal, "how much are you getting?" is rarely simple. Founders need to understand the typical components:

- **Cash on completion:** the cash to be received is typically subject to a price adjustment mechanism, where the scope for adjustment depends on whether the parties adopt a locked box (price fixed at a historical date, with "leakage" protections) or completion accounts (where the price can be adjusted post-completion based on actual financials) mechanism.
- **Deferred consideration and earn-outs:** an earn-out is a mechanism whereby a portion of the purchase price is contingent on the business achieving specified financial or operational targets post-completion. Pay close attention to how "targets" are defined, measured, and what operational assumptions underpin them. Clear drafting is important as it reduces scope for disputes.
- **Rollover equity:** where something less than 100% of the equity is being sold, Founders will typically be invited to roll a portion of proceeds into equity in the new structure so that they have an ongoing participation. Vesting terms, accelerated vesting triggers, and Leaver treatment are critical. In a minority deal, the focus shifts to anti-dilution protections, pre-emption rights, and ensuring the investor's instruments do not dilute the Founder's economic position on eventual exit.

3. Management "Sweet" Equity: Getting the Incentive Structure Right

Management equity is an area where it is particularly important that Founders fully appreciate what they are agreeing to. The points below apply primarily to majority buyouts. In a minority investment, the Founder's equity position is largely preserved, but it is important to understand how ratchet, preference, or waterfall mechanisms on the investor's shares may affect proceeds on the eventual exit. These structures are standard, but their interaction with the Founder's equity requires careful analysis. Key concepts:

- **Hurdle:** here Management equity only generates a return once institutional investors have received their investment back plus a specified return.
- **Ratchets:** these are mechanisms that increase management's share if performance exceeds targets. These are often complex formulations. They can be valuable but need careful negotiation.
- **Leaver provisions:** Good Leaver vs Bad Leaver treatment varies significantly and the financial difference can be enormous. Founders need to understand exactly what triggers each category and how it interacts with the Founder's service agreement.
- **Drag and tag rights:** in a majority deal (and in some cases, in a minority deal), "drag-along" rights allow the PE firm to require the Founder to sell on exit, in order that they can deliver

100% of the share capital to a buyer; “tag-along” rights let the Founder participate on the same terms where perhaps less than 100% is being sold. In a minority deal, the investor will rely on tag-along rights and may also negotiate co-sale rights, drag-along, put options, or contractual exit commitments.

- **Exit mechanisms:** in all investments, but perhaps especially in a minority deal, the investor will want a clear path to liquidity, whether through put options, contractual commitments to pursue an IPO or trade sale, or rights to initiate a sale process by a longstop date.

4. Governance: Post-Completion Governance

Governance changes post-completion depending on the deal structure. In a majority buyout, the Founder operates under a shareholders' agreement with detailed contractual reserved matters requiring investor consent. These are standard institutional safeguards designed to protect the investor's capital and are a feature of every PE transaction. In a minority investment, though the Founder may retain board control, the investor will still negotiate protective veto rights over key decisions, plus enhanced information and reporting rights. Given the minority position, the investor's contractual protections may be more extensive than in a majority deal, reflecting the fact that the investor does not have board control. Understanding the scope of these protections early in the process avoids surprises and allows for a more productive negotiation. Reserved matters as a minimum, typically cover:

- Acquisitions and disposals above a certain threshold
- Capital expenditure above agreed limits
- Hiring and firing of senior management
- Changes to the business plan or budget
- Incurring new debt
- Related party transactions

The reserved matters list and applicable thresholds should be discussed openly and agreed at a level that gives the Founder sufficient operational flexibility to run the business day-to-day while providing the investor with appropriate oversight. In a majority deal, the PE firm appoints a majority of board directors and expects formal reporting. In a minority deal, the investor will usually appoint board observers or non-executive directors and expect regular management information on a timetable more demanding than the Founder may be accustomed to. These governance structures are a normal part of PE-backed ownership and, when well calibrated, support rather than hinder business performance.

5. The Founder's Role, Employment, and Restrictive Covenants

As part of any PE transaction, the Founder's employment terms are typically updated to reflect the new ownership structure and governance requirements. This is standard practice and provides an opportunity to ensure that arrangements are clearly documented and aligned with the equity structure. Key areas:

- **Service agreement terms:** the Founder's new service agreement will cover salary, bonus, benefits, notice periods, and termination. The focus should be on what triggers termination and how it interacts with Leaver provisions in the equity documents.
- **Restrictive covenants:** non-compete, non-solicitation, and non-dealing restrictions will feature in both the SPA and the Founder's service agreement. Scope, duration, and geographical reach should be checked carefully, and there should be no double-counting between the two.
- **Gardening leave:** if the Founder's service agreement includes a gardening leave provision, the employer can require the Founder to remain at home during the notice period while still employed. Post-termination restrictions typically only begin to run from the end of employment, not from the start of gardening leave, which can significantly extend the overall period during which the Founder is unable to compete or solicit. Founders should check whether restrictive covenants run concurrently with, or consecutively to, any gardening leave period, and negotiate the overall duration accordingly.
- **Bonus and incentive arrangements:** understand how post-completion bonus targets will be set and by whom. In a majority deal, the PE firm controls the bonus process through the board. In a minority deal, the investor may negotiate consent rights over management remuneration above agreed thresholds. Ensure alignment with the equity package.
- **Role and reporting lines:** in a majority deal, the Founder should expect to clarify title, responsibilities, and reporting structure as part of the transaction. PE-backed businesses require defined roles and structured accountability, and the governance framework will typically be more formal than the arrangements that preceded it. Understanding who the Founder will report to, what authority the Founder retains to make decisions without board approval, and how the role may evolve over the investment period is important for both sides. In a minority deal, the Founder's role is less likely to change in substance, but the investor will typically require a level of governance discipline that may be new to the Founder and the management team.
- **Termination protection:** the Founder's notice period and payment in lieu of notice should be agreed as part of the transaction. How "cause" for summary termination is defined is critical, given its interaction with the Leaver provisions described in Section 3 above. The employment and equity documents should be reviewed together to ensure they work coherently.

6. Tax: Key Structuring and Planning Considerations

Tax planning should not be an afterthought. Three areas to focus on:

- **Business Asset Disposal Relief (BADR):** CGT at 10% on qualifying gains up to a £1 million lifetime limit. Eligibility depends on meeting specific conditions for a continuous period of at least two years prior to the disposal. Founders should confirm eligibility early and take care to preserve it: structuring steps taken in the lead-up to completion, such as share reorganisations or changes to employment status, can inadvertently disqualify the Founder.
- **EMI options:** the tax treatment of Enterprise Management Incentive options on a PE exit assuming they qualify, requires careful analysis. Timing and structuring decisions during the deal can cause options to lose their qualifying status and affect whether they qualify for favourable tax treatment. Founders and management teams holding EMI options should model the tax outcomes under different exercise scenarios and take advice before completion.
- **Management equity structuring:** how the Founder's post-completion equity is structured and how returns are characterised has significant tax implications. The distinction between returns treated as capital gains and those treated as employment income can materially affect net proceeds. It is important to ensure that any management equity is acquired at a defensible valuation and that the terms are structured to support capital treatment. These issues should be addressed at the outset of the transaction, not after the investment documents have been agreed and elections should be made to protect your position.

7. Due Diligence: Get Ahead of the Process

PE firms conduct thorough due diligence. Being well prepared demonstrates credibility and maintains deal momentum. Common areas to address early:

- Poorly documented IP ownership, particularly where contractors or early employees may have contributed to core technology
- Employment arrangements that have never been properly formalised
- Historical tax positions that have not been formally agreed with HMRC
- Customer or supplier contracts that contain change of control provisions
- Regulatory permissions or licences that do not survive a change of ownership

Experienced transaction counsel can add significant value before a formal sale process begins. A pre-sale legal review allows the Founder to identify and resolve issues that would otherwise surface during due diligence and risk becoming price chips or, worse, deal-breakers. This includes tidying corporate records, formalising employment arrangements, confirming IP ownership chains, reviewing key commercial contracts for change of control provisions, and ensuring regulatory

permissions are in order. Addressing these matters early, on the Founder's own timetable, is invariably more efficient and less costly than doing so under the pressure of a live transaction.

8. Warranty and Indemnity: Post-Completion Protection

Warranties in the SPA are a standard feature of any PE transaction. Key points for Founders:

- **W&I insurance:** warranty and indemnity insurance is now market norm in PE transactions. Where a W&I policy is in place, the Founder's personal liability under the warranties is typically capped at a nominal amount (often £1), with the buyer looking to the insurer rather than the Founder for recovery. This significantly reduces the Founder's post-completion risk, but Founders should confirm the scope of coverage and any "Exclusions" from the policy.
- **Thorough disclosure:** the disclosure process is the Founder's principal protection against warranty claims. Any matter that is fairly disclosed against the warranties cannot form the basis of a claim. The disclosure letter and its accompanying bundle should be treated as a critical workstream, not an administrative afterthought. It is time-intensive, requires input from across the business, and should be commenced early. Disclosures should be specific, accurate, and supported by documentary evidence where possible.

9. The Importance of the Right Advisers

A PE transaction involves specific deal structures and market norms that differ from trade sales. Appoint advisers with direct, recent PE experience who understand the perspectives of all parties to the transaction. The right team will model outcome scenarios, identify issues early, and keep the process on track.

Our experience acting for PE sponsors, management teams, and Founders across a wide range of sectors means we understand the dynamics from every angle. Sponsors value advisers who can manage the Founder relationship effectively and ensure that issues are resolved constructively rather than becoming obstacles to completion. That balanced perspective helps us anticipate issues, align expectations, and deliver a smoother process for all parties. We would be delighted to discuss how we can assist.

10. Key Questions Before You Begin

- Do I understand how the proposed consideration is structured and what drives the ultimate number I will receive and upfront cash?
- Have I taken tax advice on my personal position and on the transaction structure and any subsequent exit?
- Am I clear on the governance changes I will be subject to post-completion, and am I comfortable with the likely more limited level of operational autonomy I will retain?

- Do I understand the Leaver provisions in the proposed equity structure and how they interact with my service agreement?
- Are my legal advisers genuinely experienced in PE transactions, and can they advise me on what is, and is not, market standard?
- Have I considered how to organise and populate a virtual data room, and do I have access to the key documents that prospective investors will expect to review? A well-structured data room demonstrates professionalism, accelerates due diligence, and reduces the risk of delays or adverse findings late in the process. Populate it early with corporate documents, financial records, material contracts, employment arrangements, IP registrations, and regulatory filings.

If you can answer these questions confidently, you are well placed for what lies ahead. A well-prepared and well-advised Founder is not only better protected, they are a better partner for the sponsor, and that alignment is what drives successful outcomes for all parties.

We would be delighted to discuss how we can assist.

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