

# UK (England and Wales)

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## MARKET

### 1. Please describe briefly the venture capital market in your jurisdiction, in particular:

- **How it is distinguished from private equity.**
- **The sources from which early stage companies obtain funding.**
- **The types of companies that attract venture capital investment.**
- **Market trends (for example, levels of investment, the type of companies invested in and where those companies are located).**

### Venture capital and private equity

Venture capital is a form of equity investment primarily aimed at rapidly expanding, early stage, unquoted companies. It is often described as a subset of private equity. However, there are a number of key differences:

- **Age/maturity of company.** While private equity funds look to invest in established and relatively mature companies with a clear, solid trading history, venture capital funds generally invest in younger, earlier stage companies often with little trading history and few tangible assets.
- **Type of company.** Private equity funds are generally market sector neutral, provided there are sufficient profit levels and a clear business plan for the future. In contrast, venture capital funds typically invest in technology or life science sectors, backing companies with potential for rapid growth.
- **Debt.** A key feature of private equity transactions is leverage. Equity investment is generally accompanied by a large amount of debt (typically an 80:20 debt-to-equity split, although the levels of debt have fallen recently as a result of the credit crunch). However, venture capital transactions are structured predominantly through equity investment alone.
- **Control.** Gaining control of the company is a vital element in a true private equity buyout scenario, whereas usually only a minority stake is taken in a venture capital investment. However, the stake is typically accompanied by rights allowing the investor to have an element of control over the company.

- **Profit.** A private equity backed company must have sufficient cash flow to support the high levels of leverage. However, companies seeking venture capital are usually loss making and may have limited (or no) revenues, and require funds to help them become profitable.

There has been commentary recently to suggest that as a result of the economic climate, private equity and venture capital sectors are becoming more closely aligned, due to the reduction of debt leverage in private equity deals, and venture capital funds' increased interest in investing in later stage technology companies.

### Sources of funding

As well as funding from specifically created venture capital funds, there are a number of alternative ways that early stage companies can obtain funding, including:

- **University seed funds.** These are funds created by universities, predominantly through monetary input from the UK government, which are accessible to researchers within the university, and designed to aid the development of technology, resulting in a commercially viable end product.
- **Business angels.** These are typically high net-worth individuals who choose to invest directly in start-up companies, and can provide not only financing, but also vital knowledge and experience. There are believed to be around 18,000 of these investors in the UK who collectively invest approximately GB£500 million (as at 1 November 2010, US\$1 was about GB£0.6) in young businesses each year.
- **Corporate venturing.** This is a mutually beneficial relationship between a large, established enterprise and a smaller company usually operating in a related sector. The larger company will often invest directly in the smaller, and provide a skills and knowledge base or access to, for example, distribution or marketing channels that would otherwise be unavailable to the smaller enterprise.
- **Debt.** As start-ups have a short trading history, little or no income to service debt, and limited assets over which the lender can take security, they can rarely raise debt. As a company grows, it may become possible for it to raise debt, in particular from specialist providers of venture debt. This may be debt with, for example, a right of conversion into preference shares and/or an equity kicker in the form of warrants to subscribe for shares.

### Types of company

Companies seeking venture capital are often categorised as being “high risk, high return”. Venture capital funds do not generally seek to invest in traditional, mainstream companies, but rather early stage or start-up companies with a potential for significant growth. Funds typically invest their money at a stage where the company’s valuation is relatively low with growth potential to allow their investment to increase, culminating in what investors hope to be a large gain on an exit.

Venture capital is most prevalent in the technology and life sciences sectors. Cleantech companies continue to be the largest category for venture capital investment with levels remaining stable year on year from 2009. Across Europe in the first half of 2010, EUR508 million (as at 1 November 2010, US\$1 was about EURO.7) was invested in 166 companies in the sector.

### Market trends

**Level of investment.** Venture capital investments in the UK can range from small amounts to tens of millions of pounds. There has been a significant increase in the total capital invested in the last two quarters, since the low of GB£114 million in the first quarter of 2010, reaching over GB£180 million in the last quarter. This is still 12% below the level a year ago but shows that investment levels are going up. In the UK the average deal size in the third quarter of 2010 was just under GB£4 million and the largest was for GB£55 million.

**Types of companies.** Growth is continuing in the cleantech sector, continuing the trend seen in previous years, as industries find new ways to meet environmental standards set by the Kyoto protocol. These companies develop environmentally friendly products and services, which are becoming increasingly necessary for UK businesses and attractive to UK consumers. Investment in the health-care service sector is continuing and industry professionals view this as an area of significant growth in the coming years.

**Geographical location.** The location of investee companies has remained fairly consistent over the last few years. London, Scotland, east England and south-east England have been the most active areas for venture capital investment.

## TAX INCENTIVES

### 2. What tax incentive schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

#### Venture capital trusts (VCTs)

VCTs are tax efficient, closed-ended collective investment schemes approved by the UK tax authority (Her Majesty’s Revenue and Customs (HMRC)). VCTs take the form of public companies listed on the London Stock Exchange (although the legislation will be amended to allow VCTs to be listed on any EU Regulated Market (*see below, Legislative changes*)), which in turn invest in a range of higher-risk, unquoted companies. This allows investors (who hold shares in the VCT) to spread their risk across a number of different investee companies.

The UK tax reliefs available to individuals investing in ordinary shares of a VCT are:

- Exemption from income tax on dividends declared by the VCT.
- Exemption from capital gains tax (CGT) on disposal of VCT shares.
- Income tax relief at the current rate of 30% of the amount invested. This valuable relief operates by reducing the investor’s overall income tax liability for the tax year (and so can effectively be set off against all forms of taxable income, including earnings from employment), but cannot create a tax loss.

In each case, the maximum investment in a VCT is GB£200,000 in any tax year (6 April to 5 April) and no tax relief is available in relation to any investment beyond this threshold.

To avoid “claw-back” of the 30% income tax relief, an investor must normally retain the VCT shares for five years. During this period, the shares must carry no present or future preferential rights to dividends or assets on winding-up, and no entitlement can be redeemed. The relief will be denied or withdrawn if a loan is, or has been made, to the investor or any associate of the investor either in the:

- Two years before the new shares are issued.
- Following five years, where the loan in question would not have been made (or would not have been made on the same terms) were it not for the investment in the VCT.

The VCT itself is exempt from corporation tax on gains arising from the disposal of its investments.

All VCTs must be approved by HMRC for the favourable tax treatments above to apply and this approval is conditional on a number of requirements being met, including:

- The source of the VCT’s income.
- Whether the VCT’s shares are listed.
- Whether at least 70% by value of a VCT’s investments are in qualifying companies.

Only the first GB£1 million of investment in a company in any given six-month period (or, if shorter, the period between the preceding 6 April and the date of the investment) constitutes a holding in a qualifying company for a VCT. To be a qualifying company, an investee company must:

- Be unquoted (generally, not listed on a recognised or designated stock exchange in the UK or abroad).
- Carry on a qualifying trade wholly or mainly in the UK (although this requirement will be amended so that the investee company only needs to have a permanent establishment in the UK (*see below, Legislative changes*)).
- Not be controlled by another company.
- Not have gross assets exceeding GB£7 million immediately before the investment or GB£8 million afterwards.



- Not retain over 50 full-time employees.
- Not have raised more than GB£2 million in any 12-month period from VCTs (including under the enterprise investment scheme or corporate venturing scheme).

### Enterprise investment scheme (EIS)

The EIS is designed to attract direct investment from individuals in small- and medium-sized enterprises (SMEs) (in contrast to VCTs which encourage indirect investment through the VCT itself). For tax reliefs to be available to investors, they must invest into an EIS-qualifying company (the criteria for a qualifying company is broadly the same as for investee companies of VCTs (see above, *Venture capital trusts (VCTs)*)).

The relief only applies to individuals subscribing on their own behalf for new shares in a qualifying company. Individuals must not be connected with the company, and there must not be any loans made to the individual or any associate of the individual in the two years before the new shares being issued or in the following three years, where the loans would not have been made (or would not have been made on the same terms) were it not for the EIS investment.

There are also conditions attached to the use of the subscription funds by the investee company, and restrictions on the availability of relief where there are arrangements to protect investors against investment risks.

The tax reliefs available to an investor in EIS-qualifying companies are:

- Income tax relief at the current rate of 20% of the amount invested, up to a maximum of GB£500,000 per tax year. This valuable relief operates by reducing the investor's overall income tax liability for the tax year (and so effectively can be set off against all forms of taxable income, including earnings from employment), but cannot create a tax loss.
- Exemption from CGT for disposal of EIS shares, provided they have been held for three years.
- Deferral relief from CGT where any capital gain is re-invested into shares of an EIS-qualifying company. Re-investment must take place at the earliest, one year before, and at the latest, three years after the realisation of the gain. Any charge to CGT arises on disposal of EIS shares.

### Legislative changes

There are a number of changes being made to the VCT and EIS legislation to bring them within EU state aid approval guidelines.

The changes are currently passing through the UK Parliament (and so are potentially subject to change), but two of the main changes under the new rules are that:

- VCTs will in future be able to be listed on any EU Regulated Market, rather than just the London Stock Exchange.
- Qualifying investee companies under the EIS and VCT rules will no longer need to carry on a qualifying trade wholly or mainly in the UK, but they will need to have a UK permanent establishment (that is, a fixed place of business in the UK).

### Other tax reliefs

Other tax reliefs available for investments in small and medium-sized unquoted companies include:

- Relief under the corporate venturing scheme (CVS) for companies subscribing in shares in smaller, unquoted companies before 31 March 2010 (the conditions for which are similar to those for EIS relief offered to individuals). The main relief is a reduction in the investor's corporation tax liability for the relevant accounting period by 20% of sums invested in qualifying companies in that period (but it cannot create a tax loss). The CVS is no longer available for share subscriptions from 1 April 2010 onwards.
- VC loss relief, providing UK individuals and corporates relief against their income or corporation tax liabilities for losses incurred on disposals of shares in qualifying companies.

## FUND STRUCTURE

### 3. From what sources do venture capital funds typically receive funding?

Venture capital funds are typically raised through limited partnerships, and have a number of investors, known as limited partners. These limited partners comprise a diverse source of investors, including high net-worth individuals, pension funds, insurance companies, family offices, sovereign wealth funds, endowments, foundations and funds of funds.

As well as these sources of private funding, there are also a range of government-backed schemes which are designed to encourage and foster entrepreneurship, bridging the equity gap (that is, the inherent difficulty faced by SMEs in gaining funding at a very early stage of their development), and stimulate further private sector investment.

### Regional venture capital funds (RVCFs)

An RVCF exists in nine designated regions in England (similar schemes also exist in Scotland, Wales and Northern Ireland). However, the last RVCF fund ceased making new investments in December 2008, but the funds are still able to support existing portfolio businesses. The enterprise capital funds (ECF) programme has now superseded the RVCFs.

### Enterprise capital funds (ECFs)

ECFs are similar to RVCFs in that they comprise a mix of public and private funding with each GB£1 of private investor money being matched by GB£2 of government money.

Each fund is able to invest up to GB£2 million in eligible growth companies, a significantly larger threshold than allowed for RVCFs. While each fund is privately run, the overall responsibility for ECF management and the selection of funds to participate in the scheme lies with Capital for Enterprise Limited (CfEL), which is wholly owned by the UK government through the Department for Business, Innovation and Skills. A new ECF was launched in the Emergency Budget of 22 June 2010 for which private fundraising is still ongoing.

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**4. Can the structure of the venture capital fund impact on how investments are made?**

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A typical venture capital fund is usually raised subject to the terms of a limited partnership agreement, typically setting out investment objectives and other restrictive criteria. This usually includes the industry sector(s) and region(s) in which investments can be made by the fund. Except for these restrictions, a typical fund structure does not generally affect how investments are made in investee companies.

Investments through a VCT structure and/or investments into EIS-qualifying companies must be structured in a particular way to benefit from certain tax reliefs (see *Question 2*).

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**5. Do venture capital funds typically invest with other funds?**

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Over the past few years, there has been an increasing trend towards venture capital funds investing alongside other funds, and the large majority of investments are now syndicated deals. The benefit of syndicated deals is that funds can spread their money across a wider range of companies, and companies have the benefit of being able to access the collectively deeper pockets of a variety of funds.

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**FUND FORMATION AND REGULATION**

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**6. What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?**

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The most prevalent structure of a venture capital fund is a limited partnership. The appeal of this structure for venture capital investors includes that it:

- Is not subject to publication requirements (for example, the requirement to publish annual accounts).
- Provides the partners with limited liability.
- Is governed by a lighter regulatory regime than companies, and is considered transparent for UK tax purposes (that is, investors in the fund are treated as investing directly in the portfolio companies).

Although less common, companies are still prevalent, for example, a public company in the form of a VCT. These structures carry certain tax advantages (see *Question 2*), but suffer from increased regulation and publicity requirements compared to a limited partnership.

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**7. Do a venture capital fund's promoter, manager and principals require licences?**

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The promoter is not required to be authorised by the Financial Services Authority (FSA) for carrying on regulated activities under the Financial Services and Markets Act 2000 (FSMA), provided its role is confined to promotional activities (operating within applicable marketing restrictions (see *Question 8*)) and

it is not involved in the process whereby investors invest in the fund (which would often be the regulated activity of arranging investments).

The manager of the fund must (apart from a few limited exceptions) be FSA authorised to operate the fund and manage its investments (including buying/selling investments on behalf of the fund). Any other entities to which investment-related activities are delegated may also be required to be FSA regulated, such as investment advisers and custodians.

FSA authorisation is obtained by application and by satisfying certain statutory threshold conditions, including satisfying the FSA that the firm is fit and proper to be authorised. Investment managers and other key personnel must also be individually registered with the FSA as approved persons. The process of obtaining authorisation typically takes four to six months. Authorised firms are subject to minimum regulatory capital requirements, the FSA's high-level principles, ongoing conduct of business rules and various other FSA rules.

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**8. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions? Include, in the answer, any restrictions on how a venture capital fund can be marketed or advertised (for example, under private placement or prospectus rules).**

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**Investment company regulations**

Venture capital funds are typically non-retail and therefore not directly regulated themselves. It is the fund manager and other functionaries who are regulated, and the fund is classified as an unregulated collective investment scheme for UK regulatory purposes.

There are two sets of marketing restrictions:

- The financial promotions restrictions under the FSMA (where the marketing is by non-FSA authorised persons) or the FSA rules (where the marketing is by FSA authorised firms).
- Prospectus requirements.

**Financial promotions restrictions**

Under financial promotions restrictions, interests in limited partnerships (and other unregulated funds) can generally only be marketed to restricted categories of (predominantly institutional) investors, such as:

- FSA-authorised banks and investment firms, and other investment professionals.
- Large companies, partnerships, trusts and other high net-worth undertakings with assets exceeding certain thresholds.
- Certified high net-worth individuals and certified sophisticated individuals (in each case, subject to certain conditions).

An FSA-authorised firm can also promote interests in unregulated funds to additional categories of investor, such as its existing (or newly accepted) customers, where the firm has taken reasonable steps to ensure the fund is a suitable investment for the customer.

## Prospectus requirements

A prospectus complying with the FSA's prospectus rules is required to market a venture capital fund structured as a listed company.

Unlisted funds can be marketed without requiring a compliant prospectus where interests in the fund are offered to certain qualified investors and/or fewer than 100 other persons per EEA state, or within other available exemptions.

Promoters which are not FSA-authorized firms must also be careful not to be involved beyond marketing. Handling subscription documentation or monies, other involvement in the subscription process and even negotiating with a prospective investor, can all involve FSMA-regulated activities, and must be performed by an appropriately authorised FSA firm.

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### 9. How is the relationship between investor and fund governed? What protections do investors typically seek?

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The governance of the relationship between fund and investor depends on the legal structure of the fund. Most commonly, the venture capital fund takes the form of a limited partnership and a limited partnership agreement (LPA) regulates the relationship between investors and the fund. If the fund takes the form of a company, the articles of association and any shareholder agreement typically regulate the relationship.

The agreement between investors and the fund sets out the protections afforded to the investors, and covers all aspects of the fund such as formation, operation and termination, including key commercial issues (for example investment policies, profit sharing, fees and expenses), as well as administrative issues (for example information and reporting requirements). The main protections that investors into a fund seek include:

- **Purpose and operation of the fund.** The fund's investment activities are typically regulated and limited, and can include geographical and industry sector constraints, as well as limitations on the maximum size of an investment.
- **Limitation of commitment.** Investors into a fund will have a limited contribution commitment to a fund, which is often drawn down only when needed by the fund to make an investment. There will also be provisions regulating allocations, sharing and distributions of profits between the investors.
- **Expenses of fund.** The fees and expenses of operating the fund are regulated by the terms of the agreement.
- **Consent matters and information rights.** The fund is often subject to certain constraints, requiring the consent of the investors before the fund can undertake certain actions. Investors in the fund also have rights to information. A fund typically has an advisory board which often represents investors' interests in the fund on a supervisory basis, rather than taking part in the management or decision-making processes.

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### 10. What are the most common investment objectives of venture capital funds (for example, what is the average life of a fund, what return will a fund be looking for on its investments and what is the time frame within which a fund would seek to exit its investment)?

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Generally, a venture fund seeks to maximise the returns to its investors and is generally deemed a success if it can return three times the amount invested. On average, only 5% to 10% of a fund's investment will reap 80% to 90% of its return, meaning that companies which are successful must be extremely successful to compensate for the fact that a significant percentage of companies in which a fund has invested will fail.

The agreement regulating a fund is generally for a fixed term of ten to 12 years, typically with the possibility of a few years of extensions, to allow for companies still seeking liquidity. Investments from the fund are usually made in the first three to five years, following which the focus is on management and making follow-on investments in the investee companies. Finally, the focus switches to divestment and realisation of the investments.

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### 11. Are there any recent or proposed regulatory changes affecting the venture capital industry?

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The European Commission has published proposals on an EU-wide framework to regulate alternative investment fund managers (AIFM), which will affect the managers of a diverse list of asset management classes, including venture capital funds. The EU Parliament has now approved the AIFM Directive which is expected to be enacted in January 2011, with a two year implementation window for member states.

The AIFM Directive has provoked some controversy as the term "alternative investment fund" encompasses a wide range of investment funds that are not already regulated at the European level. The application of the directive to funds whose assets amount to less than EUR500 million (for unleveraged funds with long "lock-in" periods) or EUR100 million for other types of funds is limited.

The new legislation will impose registration, reporting and initial capital requirements on fund managers falling within the AIFM Directive and includes limitations on asset stripping, various remuneration practices and the use of leverage.

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## INVESTOR PROTECTION

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### 12. What form of investment do venture capital funds take?

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#### Equity

Debt is not usually available to a start-up company in its early stages, due to its limited assets, short trading history and because it has little or no income to service debt. Therefore, the investment usually takes the form of an equity investment.

Traditionally, investors subscribe for preferred shares in the company, requiring the preferential terms to be adopted in the company's articles of association. The share preferences an investor seeks in return for their investment are a matter of negotiation between the company and the investor, and can depend on the stage of the company's development. For further exploration of rights attaching to preferred shares, see *Question 17*.

#### Loan notes

Loan notes are generally:

- Only provided to existing shareholders.
- A halfway house between equity and debt.
- Used where a company is unable to raise debt, or is unwilling to issue shares at a particular stage of its development.

The most common form in the venture capital context are convertible loan notes, where the lender lends money to the company in exchange for loan notes that are convertible, possibly at a discount, into shares at a future date, or on the occurrence of certain events, such as a sale or initial public offering (IPO) of the company or an equity fundraising. If required by the lender, loan notes can be secured against the assets of the company, including its intellectual property.

#### Venture debt

Debt is not generally readily available to early-stage companies. As a company grows, so does its ability to raise debt as a source of funding, particularly from specialist providers of venture debt. Venture debt is typically a secured loan carrying an equity kicker, in the form of warrants to subscribe for shares at a fixed price, and/or an option to participate in the company's next equity fundraising.

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### 13. How do venture capital funds value an investee company?

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An investor generally invests in an investee company following a thorough appraisal of the possible or likely exit value of its investment. Investors form a view on this by reviewing industry market data on revenue, profit and M&A values for the relevant market sector.

On exit, a fund typically looks for a:

- Ten times multiple on monies invested at a pre-revenue stage of the business.
- Five times multiple on a revenue-stage business.
- Three times multiple on a business which may be about to break even and exit.

In a company's early stages, any attempt to use traditional valuation techniques such as profit/earning ratios, discounted cash flows and net present values to value the company is problematic as it is likely to require the investor to make assumptions on the levels of future revenues or profits.

However, in all cases, valuations are ultimately a commercial negotiation between the company and investor as to what proportion of the company is given away in return for the money to be invested.

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### 14. What investigations will venture capital funds carry out on potential investee companies?

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Funds typically carry out due diligence on the business, its officers and senior employees. Due diligence is an investigation and examination of the contracts, books and records of the company, to confirm information about the company's business, legal and financial affairs.

Typically, due diligence includes a review of the following, in relation to the target:

- Significant customers and suppliers.
- The background of:
  - key employment contracts;
  - material contracts;
  - facilities;
  - subsidiaries;
  - litigation;
  - insurance;
  - intellectual property rights;
  - licences and permits;
  - tax matters.

In technology and life science companies, due diligence on the target's intellectual property is particularly important, and investors may instruct a specialist research organisation to conduct an independent report on the status of the company's intellectual property.

Any significant issues highlighted as a result of due diligence can affect an investor's willingness to invest in a particular company or the value attributed to that company. Where due diligence highlights a rectifiable or more minor deficiency in the company's legal or business processes, for example, that current employment contracts are inadequate, the investor can insist it is corrected as a condition precedent.

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### 15. What are the principal legal documents used in a venture capital transaction?

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Once the investment terms of equity funding have been agreed, these terms will be reflected in an investment agreement and the investee company's articles of association.

#### Investment agreement

The investment agreement is usually entered into between the existing shareholders, the investors and the company, dealing with the share subscription by the investors and setting out the terms of the investment, including any share rights and management controls not included in the articles.

As the investor is taking some degree of risk, it will require assurances about the state of the business and, therefore, the agreement usually includes:



- Protections for the investors, such as warranties, indemnities, investor consent matters and restrictive covenants.
- Information and appointment rights, such as the right to receive financial information or to appoint a director.

### Articles of association

New articles of association are usually adopted on completion of any funding, and these set out the rights attaching to each class of share and regulate the internal affairs of the company in relation to, for example, board and shareholder meetings, powers and duties of directors, and the payment of dividends.

### Supplementary documents

The main supplementary transaction documents can include:

- A disclosure letter setting out the matters qualifying the truth or accuracy of the warranties in the investment agreement.
- Intellectual property assignment.
- New service agreements for key employees.
- Management questionnaires containing questions about management in a personal capacity.

### Agreed form documents

The investors are also likely to require the following documents to be agreed as a condition to making their investment:

- Business plan.
- The latest annual accounts.
- The latest management accounts.

## 16. What form of contractual protection does an investor receive on its investment in a company?

### Warranty protection

Investors are likely to seek extensive warranties from the company and some or all of the key employees (depending on their position and knowledge). The purpose of these warranties is to:

- Encourage pre-contract disclosure about the company, based on which investors are able to adjust their price or, in extreme cases, withdraw from the transaction.
- Provide the investors with a basis for a claim against the warrantors for financial compensation if the warranties are breached.

Warranties are likely to cover all material areas of a company's arrangements such as:

- Share capital.
- Business plan.
- Annual and management accounts.
- Intellectual property.
- Employees.
- Litigation.

- Commercial contracts.
- Insurance.
- Debt.
- Taxation.
- Real property.

Warrantors generally attempt to limit their liability under the warranties, and make disclosure against the warranties in a disclosure letter.

### Indemnity protection

During due diligence or from matters disclosed in the disclosure letter, an investor may identify particular problems with the company or its business. If significant issues arise during due diligence, an investor may request an indemnity from the founders and/or the company in relation to this issue. An indemnity differs from a warranty because it gives the indemnified party a right to be compensated on a pound-for-pound basis if the matter covered by the indemnity occurs, without needing to prove the investor has suffered actual loss.

## 17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

The founders of an early stage company hold ordinary shares and early investors, such as business angels and seed funds, may also invest in return for ordinary shares. Institutions and other later stage investors are likely to request preferred shares.

Where an investor is a VCT or it wishes to take advantage of EIS relief, some or all of that investor's investment can be made in return for ordinary shares (*see Question 2*).

## 18. What rights does a fund have in its capacity as a holder of preferred shares (for example, what rights to capital and/or to interest)?

The rights attaching to different classes of shares are typically set out in the articles of association, and vary depending on negotiations at each funding.

### Capital

Typically, on a liquidation or a share or business sale, preferred shares carry a right, in preference to all other shareholders, to receive an amount per share equal to the price paid for the share (or, more rarely, a multiple of this), plus all unpaid dividends. To the extent there are assets remaining for distribution after payment of these preferential amounts, all shareholders are likely to participate (regardless of share class) pro rata to the number of shares held by them.

An IPO can also be treated in the same way as a liquidation. If so, the investor receives a bonus issue of ordinary shares. This means the investor holds the same proportion of total issued share capital on IPO as the proportion of the sale proceeds it would receive on a sale on the same date and valuation as the IPO.

Under the articles of association, preferential rights to capital can fall away on a sale or IPO where the company's valuation exceeds a certain minimum threshold.

### Redemption and dividends

The issue of redeemable shares is increasingly uncommon in the UK venture capital market for two reasons:

- Early-stage technology companies are unlikely in most cases to have sufficient profits to be able to buy back an investor's shares, although the new share capital reduction procedure using a solvency statement may facilitate the return of capital to investors.
- Redeemable shares can be subject to reclassification under relevant accounting principles as a financial liability of the company, and this can have a negative impact from a presentational point of view in the context of a subsequent exit or funding rounds, and also in the company's ordinary business dealings with its customers and suppliers.

For the same reasons, the right to a fixed dividend is a less common feature of venture capital transactions than private equity transactions.

### Anti-dilution protection

Preferred shares held by investors will also typically carry the benefit of anti-dilution protection. The purpose of anti-dilution protection is to protect an investor from dilution as a result of subsequent issues of shares at a price per share less than the price paid by the investor. The effect of this is that all or part of the dilution resulting from any fall in the company's valuation falls on the shoulders of the non-investor shareholders.

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## 19. What rights are commonly used to give a fund a level of management control over the activities of an investee company (for example, board representation, certain acts of the company subject to investor consent)?

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### Investor consent regime

The interests of the company and the investors are likely to differ in relation to certain acts of the company, and investors want the investment agreement to set out the matters over which the investor has a right of veto, despite its minority position at shareholder and/or board level.

For example, investors typically want to ensure that certain acts of the company are not undertaken without their prior consent. These may include:

- Any form of exit event.
- Issuing shares.
- Paying dividends.
- Altering the articles of association.
- Appointing new directors.
- Certain expenditure by the company.

### Appointment of directors

Investors are likely to request the right to appoint one or more directors to the board. Some investors may prefer to have the right to appoint an observer instead of, or in addition to, a director. Investors wishing to avoid conflicts of interest or director liability may prefer to exercise observer appointment rights.

### Information rights

There is usually a specific clause in the investment agreement, stating that the investor has the right to be given certain information by the company. Typically, these rights include entitlements to:

- Examine the company's books and accounts.
- Receive the annual audited accounts.
- Receive the management accounts.
- Require the company to prepare an annual budget.

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## 20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

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Articles of association generally include provisions prohibiting shareholders from share transfers to third parties (except in certain limited circumstances), unless the shares are first offered for sale to the existing shareholders pro rata to their existing shareholdings. This not only gives the investors the opportunity, if necessary, to purchase the shares and prevent their sale to a third party (who it may, in the view of the investors, be undesirable to have as a shareholder), but also prevents other existing shareholders from increasing percentage shareholdings in the company in relation to the investor.

The articles of association can also provide the investor with an absolute veto over any transfer of shares by the founders. This is designed to ensure an alignment of interests with the founders, and ensure the founders remain with the company to work towards an exit for the company at an attractive valuation.

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## 21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company (for example, drag-along and tag-along rights)?

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### Pre-emption rights on transfer of shares

Typically articles of association contain pre-emption rights on transfer of shares, so that if a shareholder wishes to sell any of its shares, it must first offer those shares to the other existing shareholders of the company pro rata to their shareholding in the company at the same price per share.

### Mandatory offer on a change of control

Articles of association also commonly include a provision whereby if a transfer of shares would result in the buyer acquiring a controlling interest usually being more than 50% of the voting rights of the company, the transfer is prohibited unless the proposed buyer makes an offer at the same price per share to buy the shares held by all of the other shareholders.

### Co-sale

A co-sale provision requires that, if a founder or employee shareholder proposes to transfer any shares, the other shareholders are given the opportunity to sell the same percentage of their shareholding on the same terms to the proposed buyer. The co-sale provision may apply to all shareholders, rather than simply the founders and employee shareholders.

### Drag along

Articles of association also often include drag-along provisions whereby, if a given percentage of the shares are to be sold to a buyer, the remaining shareholders can be forced to sell their shares. An investor typically ensures that the drag-along provision cannot be triggered without its prior approval, so that it cannot be forced to sell when it does not wish to do so.

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## 22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

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If a company issues new shares, an investor's shareholding and its level of control can be reduced. An investor will seek, at the very least, to be entitled to maintain its percentage of shareholding. This can be achieved through pre-emption rights on a new issue of shares. More typically, in addition to pre-emption rights, an investor has a veto right on the company issuing further shares, subject to limited exemptions, such as an agreed employee share option pool.

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## 23. What consents are required to approve the investment documentation?

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### Board approvals

The company board must conclude that the fundraising and the terms of the investment documentation are in the best interests of the company.

In addition to board approval, the consents below may be required to approve investment documentation. The requirement to obtain these approvals may have timing implications on the company receiving the funding.

### Shareholder approvals

Shareholder approval is required to:

- Adopt new articles of association.
- Create a new class of preferred shares.
- Generally provide directors with authority to allot new shares.

### Class consents

If there are more than one class of existing shares in the company, separate class consents may be required to approve the investment documentation if the rights attaching to these shares are being varied. Government consultations remain ongoing to consider whether a statement of compliance is required to be

filed at Companies House, if articles of association that contain class consent provisions are amended.

### Approval of existing investors

If there are existing investors of the company, it may be that the consent of these investors is required to approve the new investment. This requirement may be found in an existing shareholder agreement.

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## 24. Who covers the costs of the venture capital funds?

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Market practice is that the investee company covers the costs for due diligence and legal fees of the investors when the funding completes. It may be agreed that the investee company covers the costs up to an agreed cap. Generally, these fees are paid directly out of investors' subscription monies.

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## FOUNDER AND EMPLOYEE INCENTIVISATION

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## 25. In what ways are founders and employees incentivised (for example, through the grant of shares, options or otherwise)? What are the resulting tax considerations?

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### Shares and options

The main forms of incentivisation for founders and employees (other than normal employment remuneration and bonuses) are shares or options. The benefit of potential capital growth incentivises employees to grow the value of the business, generates employee loyalty and aligns the investors' interests with those of the company's employees.

For further information on the issues that venture capital investors should be aware of in relation to founder shares and employee shares, including tax considerations and details on how incentives can be given to managers using EMI share options, see *PLC Corporate, Practice Note, Founder shares and employee shares*.

If an employee holds restricted shares, it may be the case that the company and the employee should enter into a section 431 ITEPA election (that is, section 431 of the Income Tax (Earnings and Pensions) Act 2003 under which an election is made to pay income tax on acquisition on the difference between the price paid and the full unrestricted market value).

### Exit bonus arrangements

It is becoming increasingly common that specific exit bonus arrangements are put in place with the management team to incentivise them towards an exit. Such an incentive scheme can range from the grant of options that are exercisable on exit, the allocation of a percentage of the proceeds on a sale, the payment of a bonus on an exit and the grant of hurdle shares where the holder of such shares is entitled to participate in the proceeds of a sale where particular valuation hurdles are achieved. There are tax considerations surrounding exit arrangements, as employees are likely to receive a benefit through employment. Hurdle share schemes have become increasingly popular as a way to grant shares or options to management in a tax efficient manner that enables them to benefit in a successful exit.



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**26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture (for example, good leaver/bad leaver provisions and restrictive covenants)?**

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**Compulsory transfers**

Typically, investors are not involved in the day-to-day management of the company, and rely on the founders' skill and knowledge to maximise the success of the company. Therefore, the investor will wish to ensure the founders remain with the company.

To achieve this objective, investors often request provisions whereby if an employee ceases to be employed by the company then either:

- He is required to offer to sell some or all of his shares to the other shareholders.
- Some or all of his shares convert into worthless deferred shares.

These are typically called good leaver and bad leaver provisions, and are generally found in the articles of association and employee option agreements.

**Restrictive covenants**

A significant part of an early-stage company's value may be tied to certain employees and the investor is likely to request that these employees covenant that they will not, while an employee or director of the company and for a specified following period, be involved in any competing business and that they will not solicit customers, suppliers or employees from the business.

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**EXITS**

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**27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?**

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By definition, the options available to realise an investment in an unsuccessful company are likely to be limited. However, the following forms of exit can be used to realise a venture capital fund's investment in an unsuccessful company:

- **Distribution of proceeds.** In which the investors rely on the liquidation preference to get back any remaining proceeds following a winding-up of the company.
- **Redemption of shares.** In which redeemable preference shares held by the venture capital fund are redeemed or bought by the company for cash.
- **Portfolio sale.** In which a venture capital provider seeking to divest a number of investments decides to sell a portfolio, generally to another investor and normally at a discounted value, by transferring its shares in several companies simultaneously.
- **Merger of portfolio companies.** In which there is a merger of two of the portfolio companies of the venture capital fund, that are in similar fields or businesses, in an attempt to streamline the two businesses and reduce administration costs.

Companies and investors have been looking to the capital reduction procedure using a solvency statement brought into force under the Companies Act 2006 as a means to create distributable reserves and enable the company to make distributions to its shareholders whether by way of dividends, share buy backs or other capital payments. However, the company must be in a position to make a solvency statement about its ability to meet its debts at the time of the statement and in the next 12 months.

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**28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company (for example, trade sale, initial public offering and secondary buyout)? What are the relative advantages and disadvantages of each?**

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The following forms of exit are typically used to realise a venture capital fund's investment in a successful company:

- **Trade sale.** This is the most common form of exit where the company's shares or assets are sold to a third party trade purchaser:
  - **Advantages.** It allows the investor to exert a significant amount of control over the process, to extract maximum value in negotiations, and is a relatively straightforward and quick procedure;
  - **Disadvantages.** Management may be concerned that the change of owner will adversely affect their positions. There may be shareholders who are reluctant to sell their shares. There may also be business risks for the company in undertaking a trade sale (for example, where the preferred buyer is a competitor).
- **IPO.** The company's shares commence trading on a public stock market. This will generally be accompanied by a primary offering by the company of its shares to new investors:
  - **Advantages.** Management may prefer an IPO as they remain in operational control of the company, and the investor may decide that it will benefit from a longer-term shareholding in the company;
  - **Disadvantages.** It is unlikely that investors or the company's directors will be allowed to sell all of their shares at the time of an IPO and, accordingly, an IPO is typically not an exit, but simply another phase in a company's life. Additionally, overall costs of the transaction are likely to be higher than other exit routes, the flotation will take longer to implement and the investor will lose all the rights and protections previously conferred by the equity documentation.
- **Secondary buyout.** The investor sells its shares in the investee company to a buyer. This is becoming a more frequently used exit option:
  - **Advantages.** It enables the investor to achieve an exit earlier than previously, as they are effectively selling on to another investor a business which is capable of further development and value;
  - **Disadvantages.** Sales can sometimes be driven by the need to wind up a fully invested fund, which may mean that the timing of the sale is not optimal.

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## 29. How can this exit strategy be built into the investment?

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To set the parameters for an exit from the outset of the investment, the initial investment documentation can contain various provisions intended to assist or clarify exit terms, and to protect the investor's position.

The reality is that an exit strategy can only be implemented and negotiated at the time an exit is under consideration, but the inclusion of these provisions provides negotiating leverage for investors with the management team and acquirers.

These provisions can include:

- An understanding that all the parties concerned agree to work together to achieve an exit as soon as reasonably practicable.

- Drag-along provisions, enabling the investor to require the sale of the entire share capital, where a particular proportion of a company's shareholders accept an offer, even if some shareholders disagree.
- Tag-along provisions, enabling the investor to require that all or a proportion of shares are sold if any other shareholder intends to sell its shares.
- A prohibition on most share sales by the management team without the investor's consent, avoiding partial sales during the lifetime of the investment.
- Liquidation and sale preference provisions under which the investor is entitled to a priority return from the proceeds of the liquidation, or sale of the investee company. Venture capital providers can also use similar terms (sometimes referred to as an IPO preference) to achieve a preferred return on an IPO.

## CONTRIBUTOR DETAILS



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**Qualified.** England and Wales, 1993

**Areas of practice.** Venture capital; M&A; technology; clean-tech and life sciences.

#### Recent transactions

- Advising Mimecast Limited, an e-mail security, archiving and compliance services company, on its GB£13 million funding from Index Ventures and Dawn Capital.
- Advising Climate Change Capital Private Equity, a fund dedicated to clean technology, on its involvement in a EUR9.1 million funding round in Nualight Ltd, a leading manufacturer of LED lighting solutions to the retail sector.
- Advising MedicAnimal Limited, an online pet pharmacy across Europe, in relation to a fundraising of GB£5 million led by Iris Capital.
- Advising Dawn Enterprise Capital Fund LP in its GB£2 million investment into IJM Enterprises Limited trading as Bathrooms.com, an internet-based bathrooms company.

**Qualified.** Canada, 1998; England and Wales, 1999

**Areas of practice.** Venture capital; technology; life sciences.

#### Recent transactions

- Advising Atomico Ventures, an early stage fund from the co-creators of Skype, in relation to their investments in Playfire, a social network for gamers and Madbid, a new online retail format for shoppers.
- Advising Seroba Kernel, Imperial Innovations and other institutional investors in relation to their GB£3.6 million investment in Veryan Medical, a company that develops muscular stents.
- Advising Amantys Limited, a cleantech spin out company from the University of Cambridge, in relation to their funding from IP Group and other seed investors.

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