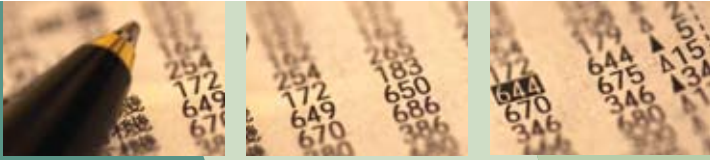


# Private Equity



An entrepreneur's  
guide

# Contents

<b>An entrepreneur's guide to private equity</b>	1
<b>Getting your house in order</b>	2
Protecting your interests	
Protecting your investment	
<b>Protecting your business - the key elements</b>	4
Employees	
Intellectual property protection	
Commercial contracts	
<b>Courting investors</b>	5
The business plan	
To whom can I send my business plan?	
Due diligence	
Term sheet	
<b>Key provisions in the investment agreement</b>	6
Subscription	
Warranties	
Matters requiring prior investor approval	
Right to appoint a director	
Financial information	
Restrictive covenants	
<b>Key provisions in the articles of association</b>	7
Liquidation preference	
Conversion of preference shares and anti-dilution rights	
Pre-emption rights	
Drag-along	
Tag-along	
Pay to play	
<b>Other documents</b>	8
Service agreements	
Share option plans	
IP transfer	
<b>Further funding</b>	8
Percentage shareholdings	
New provisions	
<b>Taylor Wessing</b>	9
Our services	

# An entrepreneur's guide to private equity

As an entrepreneur with an innovative idea, you may think that the toughest challenge you face is developing a product, but translating it into a profit making enterprise can prove to be just as tough a challenge.

There are many issues that you will have to consider such as:

- Which sort of business organisation you wish to exploit your product through (as a sole trader or through a partnership or company)?
- What rights and obligations should you and your co-founders have in the organisation's constitutional documentation (through the rules of the company (known as the articles of association) and possibly a shareholders' agreement)?
- Should you raise funds from third parties and if so, should it be through the issue of shares (private equity) or by borrowing?
- How will you respond to the demands of private equity investors, both during negotiation of the investment documents and going forward?
- When the product has been successfully developed and marketed, how will you realise a profit by way of an exit?

The aim of this booklet is to outline the key issues that must be considered before and during the fundraising process, including a review of the key terms of the investment documentation. More detailed guidance on the issues dealt with in this brochure can be found in the Tolley's Start-ups: Law and Business Handbook edited by Paul Manser and Simon Walker, partners in Taylor Wessing.

This booklet is confined to private companies on the basis that most businesses are developed through a company since it offers entrepreneurs certain protections, most importantly that of limited liability should the business not be successful. However, from a tax perspective it may occasionally be beneficial for an entrepreneur to set up business as a sole trader or a partnership. We have assumed that funds will be raised through private equity and not debt as is almost always the case with early stage companies.



# Getting your house in order

You have incorporated a company through which to exploit your business. You have your idea or product. You have a limited amount of money to finance the early stages of development. However, you acknowledge that in order to maximise the growth of your business you will have to seek external funding. So, what is the next step? How do you transform your company into what investors would consider to be an attractive investment? At this early stage you need to ensure that the company has everything it needs to develop its idea or product. With technology companies this can be distilled into two assets – people and intellectual property.

## Protecting your interests

You will need to consider whether any formal documentation regulating the relationship between you and your co-founders is necessary. As a shareholder, each founder will be able to influence the company's business by using their right to vote at general meetings. In addition, a founder may be on the board of directors. However, if one of your co-founders holds a larger equity stake in the company than you or if there are several founders all holding small stakes in the company, you may be at risk of being squeezed out of the decision making process by the bigger shareholder or by a number of shareholders acting together. Shareholders holding at least 75% of the votes can approve new articles of association. Those holding more than 50% can increase the share capital of the company, give the board of directors authority to issue shares or even remove a director. You should consider entering into a shareholders' agreement, the primary function of which is to vary the position at law by putting in protections for the minority shareholders. In particular, you will probably wish to ensure that certain shareholder matters

need the approval of a higher percentage of votes than mentioned here and that certain board decisions must be approved by specific founders.

## Protecting your investment

Usually, a technology company's biggest asset will be you and your co-founders. It is important for all concerned to ensure that you all stay committed to the company for a period long enough to realise the value of this product. Whilst you may consider it insulting to question your commitment, it is important to deal with potential conflicts and departures at this early stage. After all, the last thing you want is for one of your co-founders to leave the company and set up a competing business with the know-how acquired from their time with you. Accordingly, when structuring the share capital you should consider methods that incentivise you and your co-founders to stay with the company and penalise them if they walk out. The box opposite describes the two structures which are generally used in the alternative or are combined.



## "Vesting" shares

Here shares are issued to you at the outset but are subject to a "vesting schedule" which is contained in the articles of association. In order to keep all of your shares you are required to stay with the company for a certain period of time (typically four years). Within that period shares can vest on a straight-line basis, say quarterly, or on whatever basis you wish. Sometimes founders have different vesting schedules in recognition of their different levels of contribution to the company. If you leave within the requisite period, you keep only that proportion of those shares which are deemed to be vested. The remaining shares that are unvested lose their value either by being bought back by the company at nominal value or converted into deferred shares which have no rights attaching to them. You may decide that on certain events such as death or incapacity, where a founder's employment may terminate through no fault of their own, the vesting schedule should accelerate either partially or fully.

You may ask why a complicated share structure is necessary when the company could just grant share options which become exercisable on each vesting date. The benefit of the vesting share scheme structure over the granting of options (save for options granted under an Enterprise Management Incentive ("EMI") plan) is that taper relief for capital gains tax purposes starts to run from the date shares are issued to you and your co-founders even though they have not vested. If you were granted options, other than pursuant to an EMI plan, taper relief would not start to run until the date you exercised that option.

Further details of EMI and other share option plans are set out in our brochure entitled "Enhancing Shareholder Value".

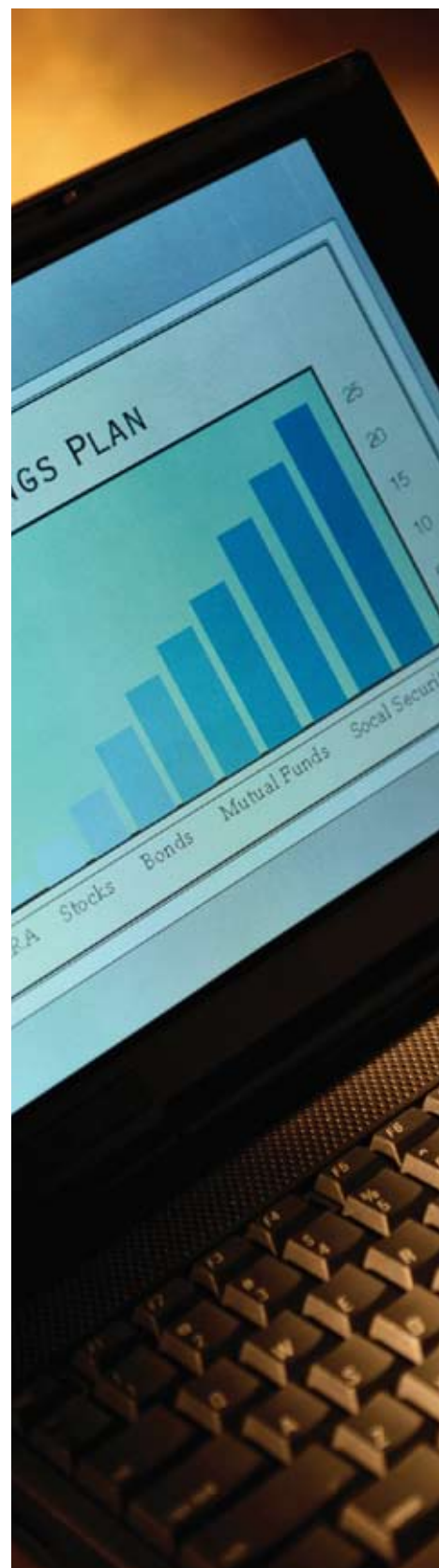
## Good leaver/bad leaver

In some cases it may not be enough that a departing founder has a reduced number of vested shares. The remaining shareholders may not want him to continue to be involved in the company by being able to vote at shareholders' meetings and will require him to offer to transfer his vested shares to other shareholders or a third party for value. What value should be paid to the departing founder for his shareholding? From the departing founder's point of view, he has already been penalised by having lost some of his shares. From the continuing founders' point of view, why should the departing founder get market value if he has left the company?

The concept of good leaver/bad leaver is often introduced to determine what price should be paid for those shares. The usual position is that a good leaver will receive market value for his shares and a bad leaver will receive the lesser of market value or nominal value, although many variations can be negotiated. The following are examples of circumstances in which a departing employee shareholder may be described as being a "bad leaver":

- breaching his contract of employment
- leaving the company voluntarily
- misconduct or repudiation of his contract of employment giving the company the right to terminate.

A "good leaver" is usually defined simply as somebody who is not a "bad leaver" and typically includes those who have ceased to be employees of the company because they are permanently incapacitated or have been constructively or unfairly dismissed.



# Protecting your business - the key elements

Protection of the business almost invariably involves three key elements:

- arrangements with employees
- intellectual property protection
- commercial contracts

although others may often arise out of the particular nature of the business proposition.

These key elements are described overleaf. Additionally, we have produced a detailed checklist for technology companies seeking investors, which is available separately.

## Employees

Founders who devote their full time to the company will in most cases be employees of the company and will be required by law to enter into a contract of employment. In addition, you may need to recruit other staff members to develop the product. Apart from ensuring that the contract of employment complies with the provisions of the Employment Rights Act 1996, there are three additional areas that the contract of employment should cover as set out in the box below.

## Intellectual property protection

In addition to securing the intellectual property ("IP") developed by the founders and other employees, the following protections need to be considered:

### Registrable intellectual property

IP which requires registration (mainly patents and trademarks) should be properly applied for, with due consideration of what, where and when to file in order to balance protection against cost.

### Dealings in intellectual property

IP developed by other companies (or individual contractors) for use in the business must be explicitly transferred to the company (the general rule being that a contractor paid to develop IP retains title, and the customer gets a licence). Where intellectual property is not to be acquired but only used under licence, the relevant rights must nevertheless be secured in writing on suitable terms, including terms as to duration and the precise scope of exploitation rights licensed.

## Joint ownership

Special care is needed where intellectual property is developed jointly, due to the very complex rules covering its ownership and exploitation.

## Trade secrets

As well as ensuring that employees do not disclose secrets, it is important to put exchanges with potential business partners on a sound footing, not only to prevent onward disclosure by others of the company's valuable secrets and to limit the purpose for a particular use, but also to avoid the secrets being 'tainted' by the secrets of others.

## Commercial contracts

These must deal clearly with rights and obligations of both sides, with special care given to the terms under which intellectual property is or has been licensed out from the company.

## Employee intellectual property

As the company is the vehicle that is being used to develop the product, it is critical that the intellectual property rights are owned by the company. You and your co-founders will need to execute a deed of assignment to transfer to the company the intellectual property that has been generated by you prior to you entering into an employment contract. Your contract should state that intellectual property rights generated by you during your employment belong to the company and similar provisions should be included in all employee contracts.

## Keeping information confidential

The company as an employer is entitled to protect its trade secrets and confidential information. This is particularly important to technology companies in the early stages of development where disclosure of confidential information into the public domain can be catastrophic, for example it could prevent a patent being granted.

## How can I prevent employees competing with my business?

Restrictive covenants are undertakings given by employees to the company whereby they agree not to do certain

things which may be prejudicial to the business. Although such covenants are a restraint of trade and may be unenforceable if they are too restrictive, they are enforceable where the company can show that they are necessary to protect its legitimate business interests. Therefore restrictive covenants which apply only through the duration of employment will usually be enforceable. However, great care must be taken to ensure that post termination restrictive covenants are reasonable. Restrictive covenants include non-solicitation of customers, non-solicitation of employees and prohibitions on investment in a business that competes with the business of the company in specific countries.

# Courting investors

Investors have to be persuaded that the company is worth investing in and a common way to do this is by setting out the company's objectives for the future and how it intends to achieve those objectives in a business plan. The business plan must be prepared thoroughly since, although it will not form part of the investment documentation, investors may insist that the directors give warranties about the truth, accuracy and preparation of the business plan.

## The business plan

A good business plan should include the following items:

- the realistic aims and objectives for the business based on reasonable and proper assumptions about the future
- how the company intends to generate revenue
- financial forecasts
- strengths and weaknesses of the business
- analysis of the market in which the company operates, such as the main competitors and customers of the business.

## To whom can I send my business plan?

The new financial promotion regime under the Financial Services and Markets Act 2000 ("FSMA") ensures that any communication which makes an invitation or inducement to engage in investment activity (such as buying or subscribing for shares) must be made or approved by a person authorised to do so under the FSMA. There are many exemptions available including communications to certified high net worth individuals and companies, certified sophisticated investors, existing members and those whose businesses involve acquiring and disposing investments (such as venture capital firms). Any business plan should state that it is only aimed at persons

falling within these exemptions. Depending on the exemptions relied on, other required wording may be necessary.

In addition, a business plan sent out as part of a fundraising exercise may also be subject to the Public Offers of Securities Regulations 1995 (the "POS Regs"). Under the POS Regs, where securities are offered to the public (or a section of the public) in the UK for the first time, a prospectus is required to be published save where the proposed investors are within an exempt group of people.

There are over 20 exemptions, but publishing a prospectus should be avoided at this stage if at all possible. Preparation of the prospectus is time consuming and can be expensive as the company and the directors will be required to make strict disclosures in the prospectus about certain company matters and each statement will need to be independently verified.

## Due diligence

Once you have found potential investors and before you get down to negotiating the investment documentation, they will want to undertake due diligence to gather more information about you, your co-founders, the company and its products. The due diligence process requires those "in the know" to divulge everything they know about the investee company to the

potential investor, enabling them to make a fully informed assessment of the value and potential of the company. It can be a tedious and time-consuming exercise, but this can be alleviated to a certain extent if you have dealt with the issues described under the heading "Protecting your business - the key elements".

## Term sheet

Once the terms of the investment have been agreed in principle, a term sheet will usually be prepared and agreed. Although the term sheet is not in itself legally binding, a carefully crafted term sheet will assist in drafting the investment documentation, as it will be a record of the intent of the parties. It should not only record the commercial terms, such as valuation, but also the rights attaching to the founder shares and the investors' shares to ensure there are no big surprises in the investment documents.



# Key provisions in the investment agreement

## Subscription

This deals with the number of shares the investor receives, the type of share (usually investors will subscribe for preference shares which have preferential rights over the founders' ordinary shares) and the subscription price paid.

## Warranties

You, your co-founders and the company will be asked to give warranties about the company, the product, the intellectual property rights relating to the product and any information (including the business plan) given to the investor. If you fail to disclose anything which makes a warranty untrue, you will be in breach of warranty and may be liable to pay the investor damages. You can, however, cap your liability under the warranties by negotiating a financial limit on your liability and ensuring the warranties expire after a certain period of time. However, in some cases a deliberate or reckless breach of warranty can be a criminal offence.

## Matters requiring prior investor approval

As the investor will usually hold a minority stake in the company, it will want to ensure that its interests are protected and that it can still exercise some degree of control notwithstanding its minority stake. An investor will usually specify certain shareholder and board matters which need the investor's or the investor director's approval, before the company can go ahead and take the action, such as varying the rights attaching to their shares, issuing new shares, entering into unbudgeted expenditure or appointing directors. The investor may agree that these rights are conditional on it holding a minimum percentage of shares in the company.

## Right to appoint a director

The investor will usually insist, subject maybe to it holding a minimum shareholding, on a contractual right to appoint one of its representatives to the board of directors or to attend as an observer. That director or his alternate will usually have to be in attendance at all board meetings.

## Financial information

The investor will usually require, subject maybe to it holding a minimum shareholding, that certain financial information is provided within an agreed period. Typically this would include rights to:

- receive the monthly management accounts
- receive quarterly reports on the company
- examine the books and accounts of the company.

## Restrictive covenants

The reason for having restrictive covenants in the investment agreement is broadly similar to the reason for having restrictive covenants in a contract of employment, that is to prevent you and your co-founders engaging in activities which may be prejudicial to the business of the company. The covenants are necessary in the investment agreement as well as contracts of employment, as this gives the investor a direct course of action against a founder in respect of any breaches.

Although restrictive covenants in an investment agreement will look similar in content to those in a contract of employment, the covenants in the investment agreement can be harsher in scope. Restrictive covenants must be reasonable. However, what is "reasonable" in a contract of employment is by reference to a person being an employee, who has a basic right to earn a wage, and therefore should not be restricted from working. In an investment agreement "reasonable" is by reference to investors being induced to invest in a company in part by the restrictive covenants. It is therefore usual to see more onerous restrictive covenants in the investment agreement than those in contracts of employment.



# Key provisions in the articles of association

## Liquidation preference

An investor will usually require a liquidation preference stating that in the event of a liquidation or winding up of the company ("a liquidity event") the investor will get a minimum sum which is equal to or a multiple of the money it has invested, before the balance of the proceeds are distributed to all shareholders in proportion to their shareholdings.

Similarly, if there is a sale of a majority of the shares of the company or its business, this will be treated as a liquidity event and the proceeds of sale distributed on the same basis.

Although a listing of a company's shares on a public market for the first time (an "IPO") is not technically a sale and therefore not a liquidity event, an investor may require that it be treated in a similar manner.

## Conversion of preference shares and anti-dilution rights

An investor will insist on having the right to convert its preference shares into ordinary shares at any time. On certain events the preference shares will convert into ordinary shares automatically, for example on an IPO. An investor may require that an automatic conversion on an IPO only happens if the shares are listed above a minimum price, which may be the same price per share as the subscription price paid by the investor.

Shares will usually convert on a one for one basis, although an investor may require an "anti-dilution right" which adjusts the conversion rate in circumstances where the company has subsequently issued new shares for less than the subscription price paid by the investor. The conversion rate is adjusted either to treat the investor as if it had subscribed for shares at the lower subscription price (full ratchet) or by taking an average across the original subscription price and the new subscription price (weighted average).

## Pre-emption rights

An investor will often insist that if the company wishes to issue shares or a

shareholder wishes to sell their shares, then those shares are offered first to the investor. There will be exceptions to this, such as issues to satisfy the exercise of share options and transfers to a family member or trust.

However an investor will not look kindly on a founder who wishes to sell out. There may therefore, be a prohibition on any such sale, usually between two and four years.

## Drag-along

It is more than likely that by the time an offer is made for the company there will be a significant number of shareholders. If an offer is made it will almost certainly be on the basis that the purchaser acquires 100% of the company. Under English law if holders of at least 90% of the shares accept the offer, the balance can generally be acquired compulsorily.

"Drag along" is a mechanism which ensures that if a specified percentage of shareholders agree to sell their shares, they can compel the others to sell. Typically the percentage will be such that neither the investors nor the other shareholders can force the sale through unilaterally.

If the founders' shares are subject to a vesting schedule, interesting questions arise on what happens on a sale of the company. Unvested shares are issued shares and the purchaser will need to acquire these shares in order to acquire 100% of the issued shares of the company. But what price is to be paid for those unvested shares? If the articles of association remain silent, then this is a matter for the purchaser to negotiate with the founders at the time of the sale and the purchaser may decide to pay the same price for vested and unvested shares, which effectively amounts to an acceleration of the vesting schedule. Whilst this is a welcome bonus to the founders, the investors will be concerned that if there is nothing to stop the vesting schedule being accelerated and the founders being bought out, a purchaser may conclude that there will be little incentive for the founders to stay with the company following its sale.

Accordingly, the investors will usually want the drag-along mechanism to be structured so that the founders can continue to be locked into their vesting schedule if a purchaser so wishes.

## Tag-along

You and your co-founders are the people who will be conducting the day-to-day management of the company and are therefore more likely to come across third parties who are interested in purchasing shares in the company. If the offer to purchase shares from a third party purchaser is an attractive offer, the investor may also wish to participate. The "tag-along" provision ensures that if a founder receives an acceptable offer from a third party for some or all of his shares (maybe subject to a minimum), he is obliged to procure that the third party also makes an offer to the investor on the same terms for the same proportion of their shares. Tag-along differs from drag-along in that there is no obligation for the shareholders to accept the offer.

## Pay to play

Investors may insist on a "pay to play" provision whereby if there is a subsequent issue of new shares and an investor fails to take up a percentage of its pro rata entitlement, it would lose its anti-dilution rights in respect of those shares and maybe also its preference rights.



## Other documents

### Service agreements

The investor may require new or varied employment contracts for the directors and other key employees.

### Share option plans

It is usual to reserve a pool of shares over which options can be granted to non-founder employees. A plan governing the share options needs to be put in place which may be an EMI, Approved or Unapproved Plan. Further details of these and other plans are set out in our brochure titled "Enhancing shareholder value".

### IP transfer

It may be necessary to settle agreements to secure the use of intellectual property rights or to formalise certain trading arrangements.

	Value	Change	%Change
	3,006.62	38.97 ▲	1.31%
	2,649.71	33.35 ▲	1.27%
	807.90	2.93 ▲	0.36%
BOX	10,744.54	96.03 ▲	0.90%
	1,367.40	13.28 ▲	0.98%
BOX	626.42	4.70 ▲	0.76%
	0.49 ▼	0.49 ▼	0.79%

## Further funding

For one reason or another, your company may require further capital to develop its product. The company is most likely to seek further equity investment from existing and/or new investors rather than through taking on borrowings.

Existing investors and/or new investors may be happy to subscribe for shares on the terms stated in the investment agreement for the first round funding (subject to a different valuation); however, there are some additional considerations that should be borne in mind on subsequent rounds of investment:

### Percentage shareholdings

If all shareholders are participating in a fresh issue of shares in proportion to their existing shareholdings, the shareholder structure will remain the same. However, if only institutional investors (existing and new) are participating, their percentage shareholdings obviously increase. In such circumstances, the founders should consider whether the larger holding would give the investors control of the company in a way they would not have had previously. For example, would the investors be able to force a drag-along?

### New provisions

Where existing investors and/or new investors are not prepared to subscribe for shares on the same terms as before, other than at a different valuation, the new documentation should wherever possible be based on the existing investment agreement and articles of association, otherwise there will be a considerable escalation of time and costs.

# Taylor Wessing

Based principally in the UK and Germany - with an office in Brussels and representative offices in Alicante Beijing and Shanghai - Taylor Wessing provides a full range of legal services to major corporations and growing enterprises doing business in Europe.

Taylor Wessing has an enviable track record in serving knowledge-based and technology-orientated businesses. A market leader in intellectual property, the firm also has a strong market presence in corporate finance, private equity, projects, real estate finance and inward investment.

A number of the lawyers in our Technology and Life Sciences Group have science degrees and many have worked in-house and/or been seconded to technology-based companies. The combined strengths of the team, including our knowledge of international intellectual property rights and our extensive international connections, mean we are ideally placed to meet the needs of technology

companies and their investors.



Berlin Brussels Cambridge Dubai Düsseldorf  
Frankfurt Hamburg London Munich Paris  
Representative offices: Beijing Shanghai  
[www.taylorwessing.com](http://www.taylorwessing.com)

**London**

5 New Street Square  
London EC4A 3TW  
United Kingdom  
Tel +44 (0)20 7300 7000  
Fax +44 (0)20 7300 7100  
[london@taylorwessing.com](mailto:london@taylorwessing.com)

**Cambridge**

24 Hills Road  
Cambridge CB2 1JP  
United Kingdom  
Tel +44 (0)1223 446400  
Fax +44 (0)1223 446401  
[cambridge@taylorwessing.com](mailto:cambridge@taylorwessing.com)

Taylor Wessing LLP is an ISO14001 environmentally certified partnership.

This marketing communication is printed on sustainably produced paper.



Certificate No. EMS 532521

© Taylor Wessing LLP 2009

This publication is intended for general guidance only and no responsibility is accepted by Taylor Wessing LLP for any errors or omissions. The information in this publication should not be relied upon to replace professional advice on specific matters. Taylor Wessing LLP is a limited liability partnership registered in England and Wales, registered number OC322935, with its registered office at 5 New Street Square, London, EC4A 3TW.

Taylor Wessing LLP operates in combination with associated legal entities in other locations.