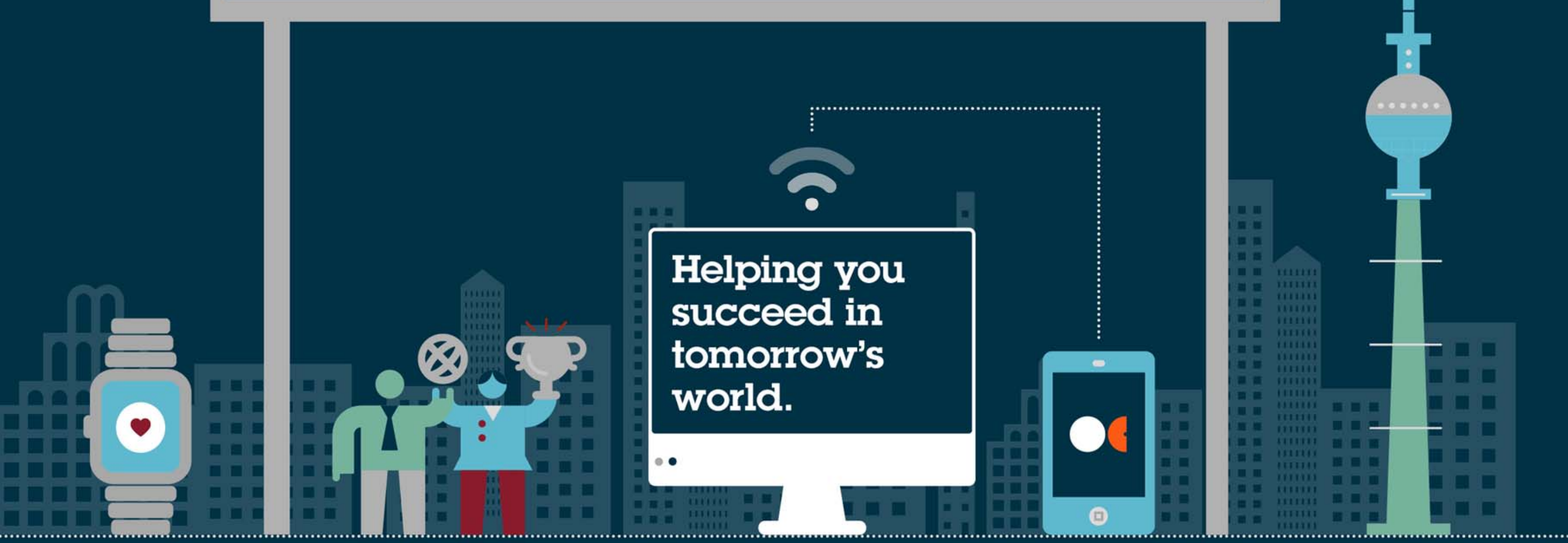
Osborne Clarke

Venture Capital Investments



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This transaction guide provides an introduction to venture capital investments and the key parties and documents involved.

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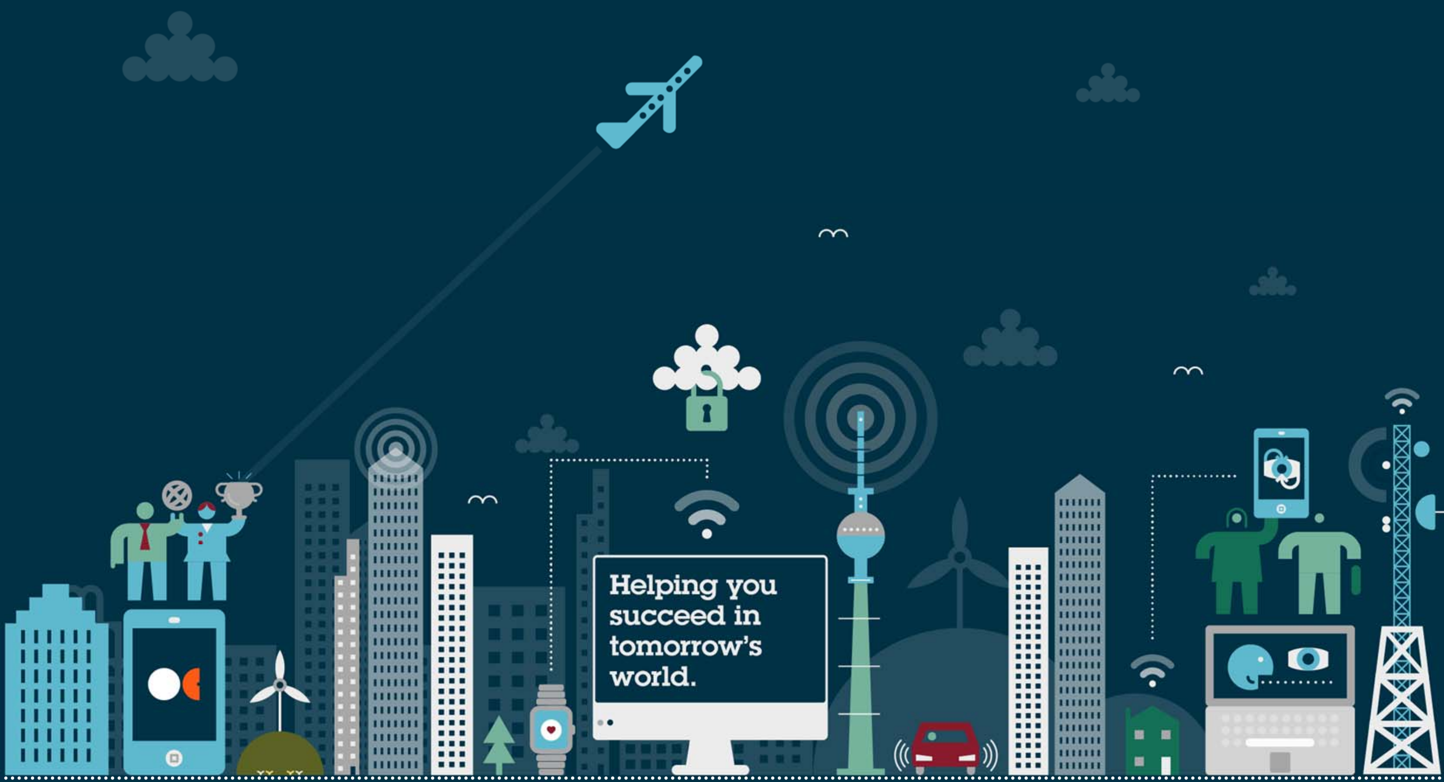
What is venture capital and where does it come from?



What is venture capital and where does it come from?

Venture capital is finance provided to high-growth private companies which are at an early stage in development or are seeking to expand. Venture capital is a form of private equity, but that term is generally used to refer to the financial package provided to support buyout and buyin deals.

Venture capitalists ("VCs") invest in companies which generally have few assets and may not even be profitable. VCs will not expect to generate the majority of the return on investment directly from the trading profits of the company, but rather from its growth and eventual sale or listing on a stock market. This type of investment is therefore extremely risky, but can generate exponential returns for the VC.

Venture capital in the UK can come from a variety of sources, some of which are referred to below, but whichever type of investor provides the funding, the structure of the investment will be broadly the same.

Business angels

Business angels are wealthy individuals who will generally invest relatively small amounts (say £100,000) in order to get a business on its feet and perhaps to support it to its first institutional funding round. There are networks of business angels that invest together to support slightly larger funding requirements.

Corporate venturing

Corporate venturing is where a large corporation takes an equity stake in a developing business. For example, many of the large well-known telecoms and technology companies will invest in small businesses, with the intention of benefiting from the relationship to provide value to its own business. Corporate venturers can invest significant sums, often millions of pounds, either on their own or as part of a syndicate with other investors.

Venture capital funds

Venture capital funds are managed funds, often consisting of institutional finance, but may also be raised from private individuals (e.g. venture capital trusts – known as "VCTs" - which are venture capital funds listed on the stock market and funded by private investors or enterprise investment scheme funds known as "EIS Funds"). Venture capital funds are managed typically by a firm that will identify, review and negotiate the terms of the investment on behalf of the funds themselves.

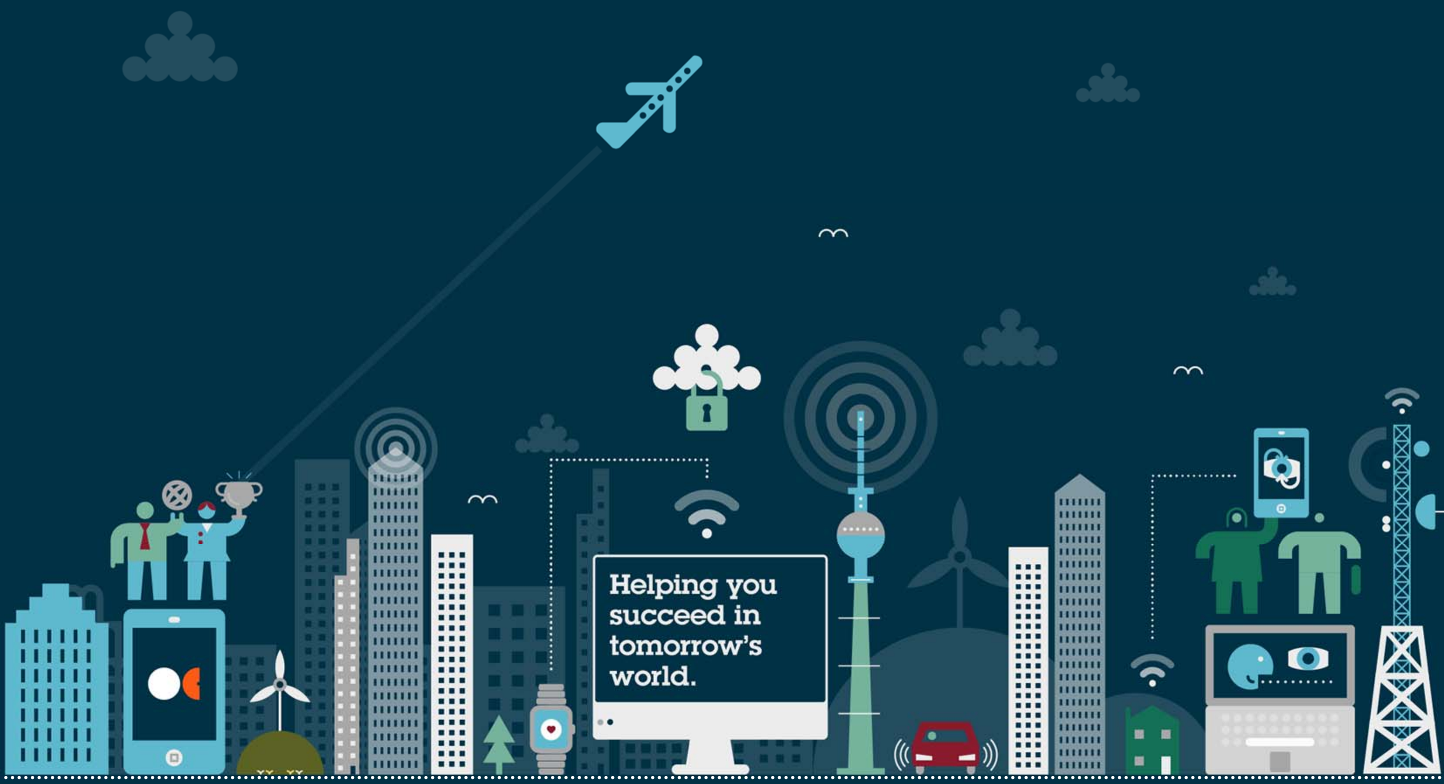
Most UK venture capital funds are members of the British Venture Capital Association ("BVCA"), and a directory of members can be found on its website (www.bvca.co.uk).

However, the VC industry is very international and cross-border financings are very common. In particular, a significant proportion of venture capital funding made into UK companies comes from US-based VCs, generally head quartered on either the West Coast (San Francisco/San Jose) or East Coast (New York/Boston).

Venture capital funds invest millions of pounds into companies they back, either alone or in a syndicate with other investors.

Venture capital investments are often made in stages over the lifetime of a company's development. These stages are often referred to as seed, Series A, Series B, etc.

02 Other parties involved in venture capital investments



Other parties involved in venture capital investments

Corporate finance advisors

Corporate finance advisers can help you to prepare your business plan, understand the valuation of your business (see section 4: Common issues) and negotiate this valuation with potential investors. Most of the large accountancy firms have corporate finance arms, and there are also smaller boutiques that specialise in particular sectors or geographical areas.

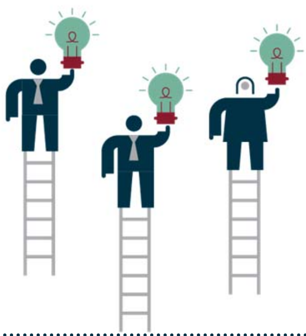
Lawyers

Both the VC and the company receiving investment will appoint solicitors. The solicitors will generally be responsible for identifying and dealing with any legal issues that might affect the valuation of the business, and ultimately for negotiating and documenting the terms of the investment.

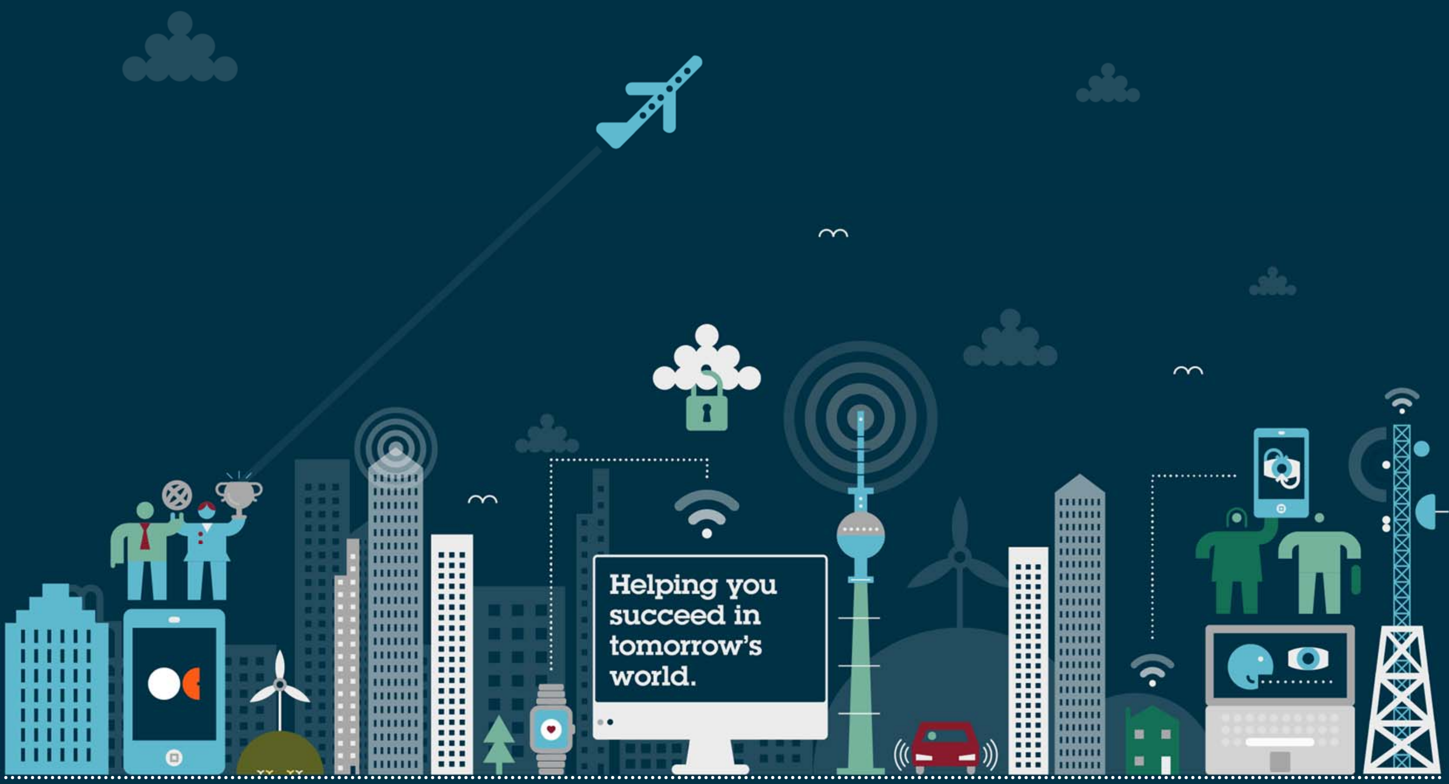
It is important to appoint solicitors with sufficient experience and expertise in VC transactions to advise the company and its management team properly. The law firm should also have a certain level of sector knowledge in order to understand the value in the business of the company, and therefore what is important in the context of the deal.

Due diligence advisers

In order to protect the value and to understand the growth potential of the business, the VC will want to investigate the company's employees, products, intellectual property, trading and legal standing. The VC may carry out this process itself, or it may employ professional or industry experts to compile reports on these areas. The approach taken will often depend on the amount being invested and the individual approach of the VC.



03 Key documentation



Key documentation

Term sheet

Once the basic terms of the investment have been agreed between the parties, they will generally be documented in an offer letter or term sheet. It is important that the term sheet covers all key commercial areas of agreement, while avoiding the level of detail that will ultimately be covered in the legal documents. A properly drafted term sheet can avoid many weeks of negotiation and professional costs.

However, it is important that the professional advisers (lawyers and corporate finance advisers) have reviewed and commented on the term sheet before it is agreed and signed. Once the term sheet has been signed, it is difficult for parties to materially move the agreed position at a later date.

Due diligence

As referred to above, the VC will wish to carry out some level of investigation into the company. The extent of investigation will vary depending on the position of the company (i.e. its stage of development, whether it has ever traded, etc) and the amount of the investment. It is fair to say that VCs take significantly differing views as to the level of due diligence required.

Typical subjects of investigation will be:

- Legal – normally as a minimum would cover:
  - the company's constitution – ensuring that it is properly incorporated and understanding the ownership of its share capital;
  - share option schemes – in order to understand the equity ownership;
  - employment contracts – to ensure that staff are employed on proper terms; and
  - intellectual property ("IP") – to ensure that the company's IP is properly protected;
- Financial – (if the company has traded) to ensure that the VC is comfortable with the basis on which the business plan and projections have been based; and
- Commercial – looking at the company's products, competitors and potential for growth, possibly by obtaining a report from an industry specialist or simply by talking to relevant parties.

It is wise to pre-empt a due diligence investigation and to take advice as to how to deal with any issues which are identified.

Investment Agreement

The Investment Agreement and articles of association (see below) are the principal documents relating to any venture capital investment. These documents reflect the commercial terms agreed in the term sheet, but at a level of legal detail intended to make the rights and obligations of the parties absolutely clear.

The Investment Agreement, also sometimes referred to as a subscription agreement or a subscription and shareholders' agreement, will document what the VC gets for its money and the ongoing relationship between all of the parties (i.e. the VC, company and management).

These latter terms are sometimes contained in a separate agreement referred to as an 'Investor Rights Agreement', but it is more usual for all terms to be covered in the same document.

The key issues, which will generally be covered, are set out below.

- Form of investment
  - A venture capital investment will normally take the form of some kind of 'preferred equity' (shares with preferential rights). This means that the VC will take a share in the company (entitling it to a share of income, capital and to vote with other shareholders) but subject to preferred terms. More detail on the nature of the preferred terms is set out below.
  - Sometimes the investment may be made via 'preference shares' or 'loan stock', both of which generally provide a fixed income and capital return.
- Warranties
  - Warranties are a set of statements provided by management and the company itself as to the status of the company and its business. They are intended to supplement the VC's due diligence, by attaching a liability to the accuracy of the information supplied.
  - Typically, warranties will cover matters such as the business plan (to ensure assumptions and projections are reasonable and achievable) and due diligence reports (to ensure that the factual information, on which the VC is basing its investment case is correct) as well as other general trading matters.
  - The warranties are normally supported by personal liability on the part of the directors up to a set amount (usually based on a salary multiple). The company's liability is usually capped at the full amount of the investment. They will also be qualified by the contents of the disclosure letter (see below). Due to the nature of the relationship between the VC and management, claims under Investment Agreement warranties are very rare in practice, other than in the case of fraud.

Key documentation

- Restrictions
  - These will take the form of a list of matters which the company will be prevented from carrying out without the prior consent of the VC (such as issuing new shares, selling its business, incurring debt, employing senior staff, etc.). These vetoes should cover matters outside the ordinary course of the company's business, so as not to be overly restrictive, whilst still protecting the VC's position so that extraordinary decisions cannot be taken without its consent.
- Undertakings
  - The VC will expect the business to be properly run, for board meetings to be held regularly and possibly for the creation of remuneration and audit committees. The company and management will be required to undertake to the VC that this is the case. In addition, the VC will normally require the right to appoint a director to attend (and to be paid an annual fee for the attendance at) board meetings, and to monitor its investment.
- Provision of information
  - Typically, the VC will require copies of accounts, management accounts, business plans and board papers to be provided promptly, and will expect the right to appoint investigating accountants if these are not forthcoming.
- Restrictive covenants
  - The value of the VC's investment would be significantly threatened if the company's management team were to leave and set up a competing business. The Investment Agreement will therefore contain restrictions on the managers (which are enforceable by the VC) for the duration of their employment (or sometimes for such time as they hold shares in the company) and a period after that. These restrictions will normally prevent the managers from competing with the company or hiring its senior staff.
- Negotiation fee
  - The VC will often charge a fee on completion of the investment, normally equal to between 1% and 2% of the total value of the investment. This is particularly common for VCTs and EIS Funds.
- Other
  - The Investment Agreement may contain other provisions depending on the nature of the VC investing. If the VC is a VCT or EIS Fund, it will need additional provisions to ensure that the company qualifies for the special tax treatment afforded to these types of investment (see section 5: Tax considerations).
  - VCs from non-UK jurisdictions may also require specific provisions to ensure compliance with their domestic securities laws.

Articles of association

As referred to above, a VC's investment will usually be made via the issue of preferred equity. The company, therefore, will need to adopt articles of association which reflect the preferential terms applying to these new shares.

The rights attaching to these shares will normally be more favourable than those applying to ordinary shareholders' shares, and the main points will be contained in the term sheet agreed at the outset of the deal.

The key issues are generally as follows.

- Dividends
  - VCs in early stage companies will rarely require the payment of a dividend in the early years. This is because they will not expect the company to be making profits, but also that they would expect any profits made to be reinvested in the company's research and development and growth.
- Return of capital
  - The VC's investment will normally benefit from a liquidation preference, which means that when the company is sold, or capital otherwise returned to shareholders, it will be entitled to a sum equal to the value of its investments (or sometimes a multiple of such sum) before any other money is paid to other shareholders. After payment of the liquidation preference, the remaining proceeds are typically split prorata among all shareholders or just the ordinary shareholders (see Section 4: Common Issues).
- Voting
  - The VC's shares will generally carry votes on the same basis as the ordinary equity shares in the company. However, such voting rights are sometimes enhanced, e.g. if the company fails to perform to plan.
- Leaver provisions
  - A VC will generally require the founders/managers to lose all or a portion of their shares on ceasing to be employed by the company. This is because it is important to maintain a pool of shares sufficient to motivate the managers to deliver value to shareholders, and it is often not helpful to have

Key documentation

non-active shareholders as investors in private companies. Sometimes shares will convert into worthless "deferred" shares or be required to be offered for transfer; the proportions of and price at which such shares are to be transferred will generally depend on conduct (e.g. whether a 'good leaver' or a 'bad leaver') or time (where the value of shares increases over time – a 'vesting schedule'), or often a combination of the two.

  – In venture capital deals it is often possible to distinguish between directors who are founders and those who are managers. In the case of the former, it is often the case that the company will outgrow the original founders, and a management team with additional skills is brought in to manage the business going forward. This does not mean that the founders should be left with no part of the future growth of the company, and so leaving founders may be entitled to retain shares, although any shares retained would generally be disenfranchised so that leaving founders no longer have a say in any voting matters.

- Board appointment rights
  – Typically, a VC will want the right to appoint a nonexecutive director to the board of the company, and may also require the right to appoint additional observers to attend board meetings.
- Anti-dilution
  – As mentioned in section 4: Common issues, one of the most difficult aspects in making investments into private companies is valuation. In order to mitigate against over-valuation, the VC will often include a provision in the company's articles of association which will state that if the company issues more shares at a lower price than that paid by the VC (therefore implying that the VC overpaid), it will issue free or cheap shares to the VC so that the average price paid for all shares held by the VC is reduced.
  – There are a number of methods of calculating how many new shares would be issued under these provisions, and the effect of them can be dramatic on ordinary shareholders. Proper advice, therefore, should always be taken in respect of such provisions.

'Drag and tag along'

As mentioned at the outset of this section, VCs will seek to make a significant return on an investment in the company when it is eventually sold. It will, therefore, not want a minority of shareholders to be able to prevent a sale of the whole share capital if such sale is approved by the majority. A 'drag along' article is therefore often included in the company's articles of association, which will allow a majority (say 75%) to force the minority (25%) to sell.

Similarly, if there is a sale of a majority of the share capital, the VC will want to ensure that it has the ability to participate in that sale. If the VC, therefore, holds a minority (say 25%) and the majority sell, then it will want the right to sell to the buyer at the same time, on the terms provided for in the articles (i.e. 'tag along').

Service agreements

To ensure that the management team devote its full time and attention to developing the company's business (and therefore increasing the value of the VC's investment,) the VC will want to ensure that managers are employed on contracts which contain proper protection for the company.

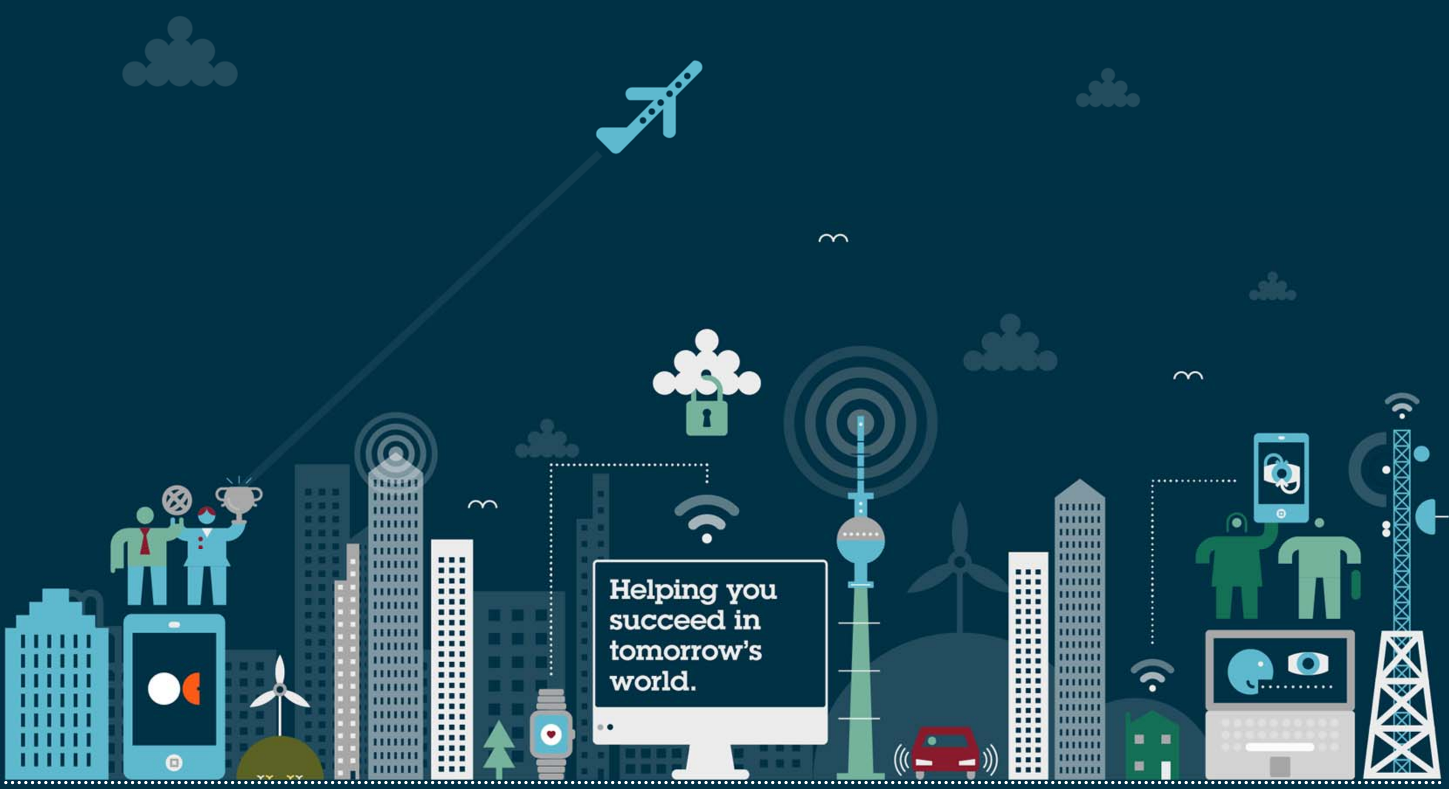
This will normally mean including provisions such as restrictive covenants, intellectual property assignment provisions, notice periods of six months or less, pay in lieu of notice clauses (allowing the employee to be dismissed immediately in return for payment of his salary during the notice period) and garden leave clauses (allowing the company not to require the employee to attend work during the notice period), as well as making sure that the contract properly reflects the executives' remuneration package (including any bonus arrangements).

Disclosure letter

This document contains the disclosures against the warranties contained in the Investment Agreement. As with warranties in a share purchase agreement, the warranties in the Investment Agreement will tend to be framed in absolute terms, so the disclosure letter will set out exceptions.

Its format will be similar to a share purchase disclosure letter, but VCs will not generally accept lengthy general disclosures, accepting specific disclosures only. This is a reflection of the fact that warranties in an investment situation are much more aimed at information gathering than allocation of risk.

04 Common issues



Common issues

There are any number of matters which might prevent a venture capital investment completing smoothly. The following are some of the most common.

Valuation

It is very difficult to value private companies. Unlike public companies quoted on a stock market, there is no 'market price' for shares in private companies, and VCs, therefore, have to use other valuation methods. These will normally include looking at comparable businesses or applying a multiple to the company's revenue or profit. It is in all parties' interests to ensure that the valuation methodology used is as robust as possible. Clearly, the company and its management will wish to argue a higher valuation, but ultimately, over-valuation will cost the ordinary shareholders through the operation of provisions such as liquidation preference and anti-dilution.

Share ownership clarity

Start-up companies sometimes fail to take appropriate advice when issuing shares to its management team. It is vital that the ownership of shares and options is absolutely clear to incoming investors. Failure to take proper advice can not only result in complications in relation to the investment but can also result in significant adverse tax consequences for individual shareholders.

Liquidation preference and anti-dilution

As referred to in section 3: Key documentation, these provisions are intended to protect the VC against over-valuation and guarantee a profit on sale. One of the main problems in companies securing multiple funding rounds is that each round will often (depending on the negotiating power of the parties) wish to have equal or greater rights than those attaching to the previous round. It is not difficult, therefore, to see that this can result in the value attributable to ordinary shareholders being squeezed out completely.

Thus, it is important to ensure that these provisions are properly negotiated, so as not to leave the company and its ordinary shareholders in a weak position in future rounds or on a sale.

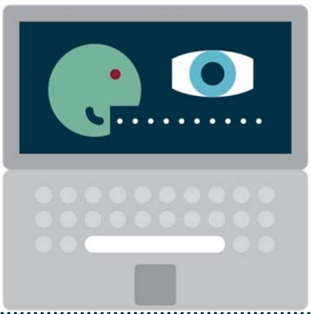
Value protection

The value of most companies obtaining venture capital investment will be in their IP and people. Failure to protect IP properly via contractual and registration arrangements, or failure to ensure that key personnel are employed subject to terms which properly protect the company, will require these issues to be rectified prior to the investment completing. This often leads to frustration and delay during the investment process.

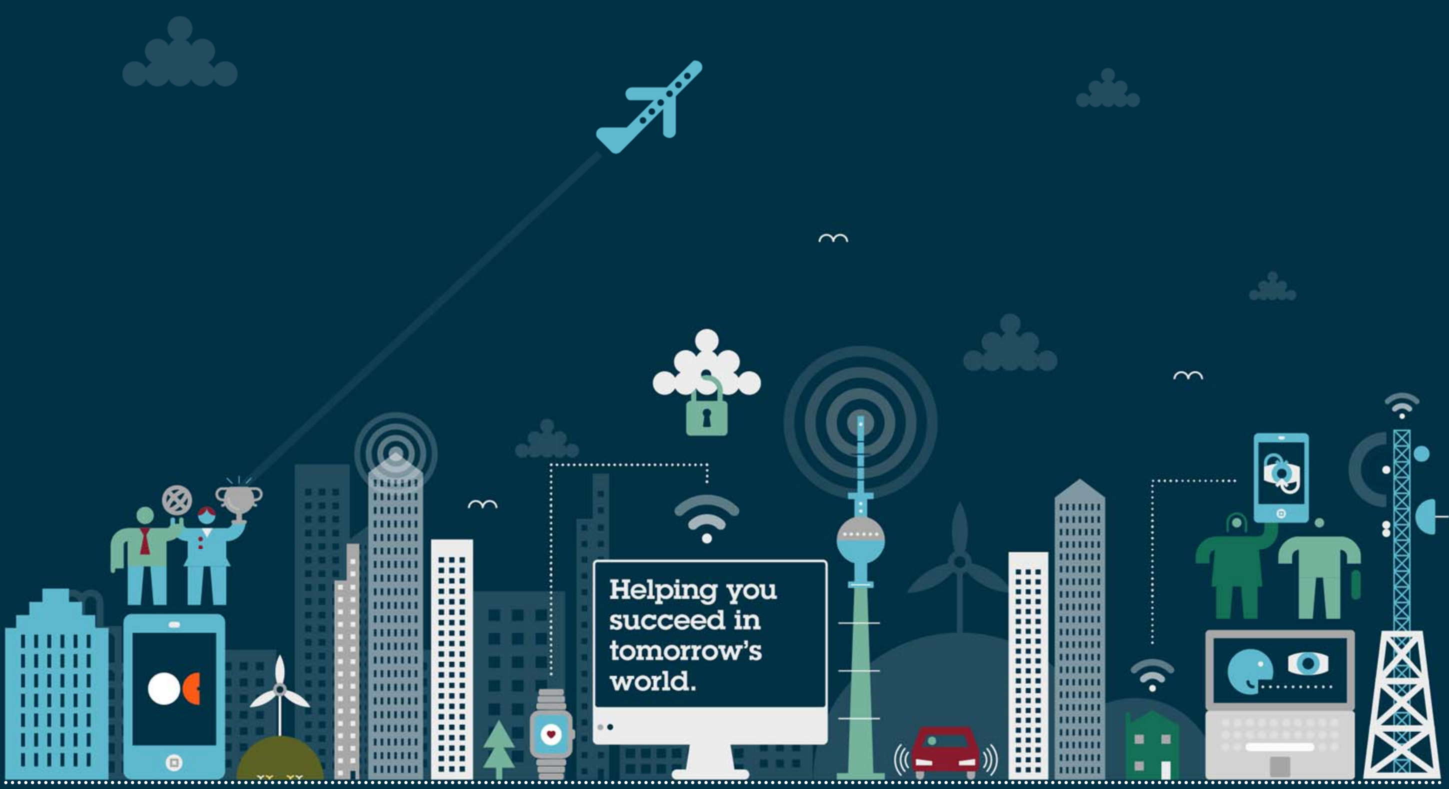
Understanding expectations

A venture capital investment necessarily means founders will need to relinquish an element of control of their company. Lawyers will be able to advise on what is reasonable/common in the market. It is a founder's prerogative to argue against these principles, but it will often result in frustration and delay, and may not actually change anything.

Contract negotiation can be confrontational if not handled correctly. It is important at this formative stage of the relationship between VC and company to put the documentation and liabilities into commercial context.



05 Tax considerations



Tax considerations

The tax efficiency of any investment needs to be considered in respect of the company and the VC.

The company

The tax treatment of the company invested in is of interest to the VC, as it will affect the amount of return on the investment.

Any expenditure that is tax deductible will ultimately reduce the tax liability of the company or its group, and so is desirable for all. Any interest paid on any debt will be tax deductible as long as the debt is on arm's-length terms and is not considered excessive by HMRC. If the debt is not on arm's-length terms, transfer pricing rules may apply, and deductions in respect of the excessive interest be denied.

Dividends paid are not tax deductible.

VCs

Each VC will have different tax considerations which may influence the proportions of debt and equity that the VC is prepared to invest. Tax considerations are of particular importance to VCTs and EIS Funds.

Preferential tax treatment is given to investments by VCTs and funds or individuals who qualify for relief under EIS.

In both cases, the investors will wish to ensure that their investment will qualify under the VCT or EIS rules.

The tests under the VCT and EIS rules last for some years, so it is usual for the company and the management shareholders to be subject to undertakings designed to ensure that it will continue to qualify under the rules for the requisite periods.

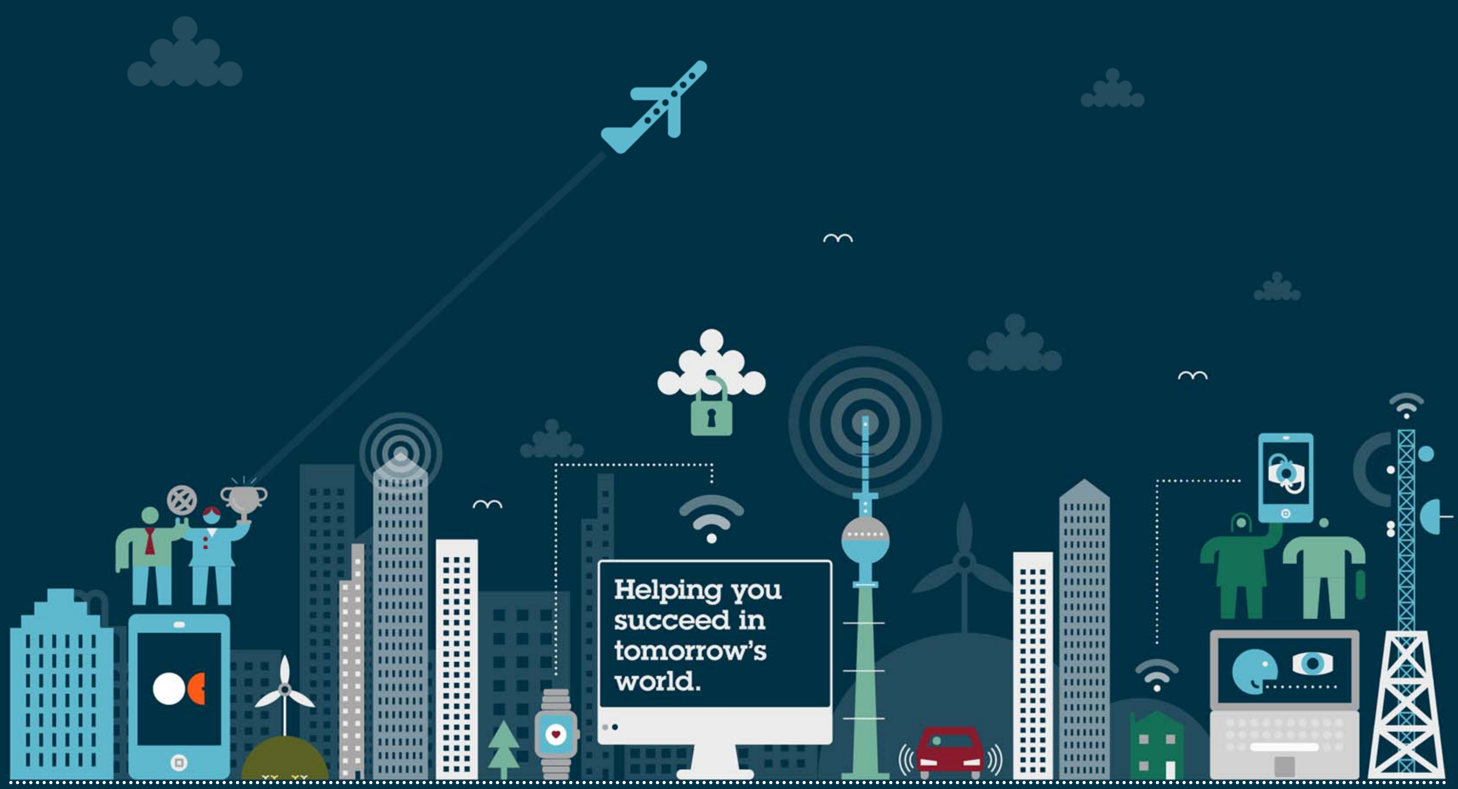
Managers

Any individuals who are resident in the UK who take shares or securities will be subject to capital gains tax on any gain from their investment. However, any employees or directors (managers) of the company or its group who take shares will be deemed to have acquired "employment related securities", and as a result managers have to pay the full unrestricted market value for their shares on day one (i.e. ignoring any restrictions that may apply to the shares which reduce the value). If there are restrictions that affect value, and the manager only pays the restricted price, then the manager will be exposed to income tax charges which will crystallise on certain trigger events, including sale, and will also be subject to a special set of income tax rules.

An election (known as a section 431 election) can be signed to deem that the unrestricted price has been paid. If an election is signed but the unrestricted price has not been paid then an income tax charge will arise at the point of making the election but no further income tax charges will arise. HMRC have agreed with the BVCA that if the investment is structured in a certain way, then the manager can take comfort that the unrestricted price has been paid.

In certain circumstances, especially on sale, any income tax charge that does arise will fall to the company to collect and pay through the PAYE system. In these circumstances, national insurance will also be due. It is standard practice for the Investment Agreement to contain an indemnity from the managers in respect of any tax paid by the company through PAYE, and any national insurance paid. However, employer's national insurance is only recoverable in certain circumstances.

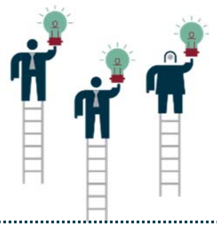
06 Summary



Summary

- Venture capital is finance provided to high-growth companies which are at an early stage in development or are seeking to expand.
- The investment is not expected to generate the majority of return on the company's trading profits, but rather from its growth and eventual sale or listing.
- Venture capital in the UK can come from a variety of sources, the most common of which are business angels, corporate venturing and venture capital funds, both UK and internationally-based.

- A venture capital investment involves a variety of parties, including corporate finance advisers and lawyers (for both the company and the VC).
- The key documentation in a venture capital investment is the Investment Agreement and articles of association.



- The Investment Agreement documents what the VC gets for its money and the ongoing relationship between the parties. The agreement will generally include warranties, restrictions, undertakings, restrictive covenants, provision of information terms and transaction fees.
- The articles of association will provide for the VC's preferential share rights, including provisions relating to dividends, return of capital, voting, leaver provisions, board appointment rights, anti-dilution, and 'drag and tag along'.

- It is vital that the ownership of shares and options is absolutely clear to incoming VCs, and so taking proper advice when issuing shares and options can avoid future complications.
- The value of most companies will be in their IP and people. Failure to protect either of these assets properly will delay, and may even prevent, the investment.

- The tax treatment of the company invested in is of interest to the VC as it will affect the amount of return on the investment.
- In addition, each VC will have different tax considerations of its own that will influence the preferred deal structure.

About Osborne Clarke

Our global connections and 'best friends'

Through a network of 'best friends' we extend our reach across the globe, particularly in North America, EMEA & Asia Pacific. We have worked closely with like-minded firms in over 100 countries. We'll find the right local partner for you and wherever that may be, we will make sure that you receive the Osborne Clarke level of service.

Europe

Belgium: Brussels
France: Paris
Germany: Berlin, Cologne, Hamburg, Munich
Italy: Busto Arsizio, Milan, Rome
The Netherlands: Amsterdam
Poland: Warsaw
Spain: Barcelona, Madrid, Zaragoza
Sweden: Stockholm
UK: Bristol, London, Reading

USA

New York, San Francisco, Silicon Valley

Asia

China: Shanghai
India*: Bangalore, Mumbai, New Delhi
Singapore

1080+

talented lawyers

working with

300+

expert Partners

in

26

international locations*

advising across

8

core sectors

with

1

client-centred approach

*Services in India are provided by a relationship firm

October 2022