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british business angels association

THE BRITISH BUSINESS ANGELS ASSOCIATION AND EVERSHEDS LLP

IMPROVING THE INVESTMENT PROCESS:

THE STANDARD LEGAL DOCUMENTS AND HOW TO USE THEM

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1. INTRODUCTION

This guide has been written to assist business angels (the name given to those individuals who are prepared to invest their money and often their time into start-up or early stage businesses) and entrepreneurs involved in raising funds for a growing business, as they navigate the legal process to ensure their investment deal creates a mutually beneficial partnership.

We recognise that, having reached an agreement in principle to proceed with an investment, both entrepreneurs and angels would like the legal process to be as efficient and cost-effective as possible, whilst delivering the contractual protection they each require. As a result, Eversheds has been working alongside the British Business Angels Association to produce the set of precedent legal documents that accompany this note in order to deliver the following benefits:

- **Lower legal costs** – the initial drafting costs and costs of reviewing are expected to fall, particularly relevant in smaller deals where the cost of legal documentation may be considered disproportionately large having regard to the amount being raised;
- **Reduced negotiation time** – the documents reflect standard tried and tested industry practice and an even-handed approach, enabling agreement on commonly negotiated points to be reached quickly;
- **Improved education** – by using an industry standard set of documents, the knowledge of entrepreneurs and angels of the investment process will be improved; and
- **Reduced friction in transitioning to the next round of funding** – it is likely that investee companies will seek additional funding in the future, whether from angel syndicates, early stage VCs or more mature private equity investors, and the existence of (and adherence to) the BBAA standard documents will provide reassurance to these investors at the time of future fundraisings.

To deliver these benefits, and ensure that the interests of entrepreneurs and angels are appropriately protected, it is vital that appropriate professional advice is taken at an early stage. This need not be prohibitively expensive – indeed, one of the objectives of the standard investment documents is to enable lawyers to provide meaningful cost estimates and fixed fees at the outset.

We hope that this note, and the documents which it accompanies, lead to real improvements in the investment process for entrepreneurs and angels alike. If you have any feedback, whether positive or otherwise, please let us know – we would be delighted to hear from you.

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2. THE INVESTMENT PROCESS

2.1 Financial Services and Markets Act 2000 (“FSMA”)

Before embarking upon a fundraising exercise, entrepreneurs should ensure they understand the legal and regulatory framework within which they are operating. The main pieces of legislation are FSMA and the Financial Promotion Order 2005 (“FPO”), which contain the following important provisions.

Financial Promotion

The FPO provides that “a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity”. This does not apply if the person is an authorised person under FSMA or if the contents of the communication are approved by an authorised person. However, these exemptions are likely to be a little use to an entrepreneur seeking to raise finance and therefore further consideration of the relevant circumstances is required.

Fortunately, there are other relevant exemptions for individuals or companies communicating business plans to potential investors. In the context of business angel finance, the relevant exemptions are:

- **High net worth individuals** - business angels may have signed a certificate exempting them from the general financial promotion restrictions of FSMA. In order to do so, the individual must have an annual income of not less than £100,000 or net assets to the value of not less than £250,000, both as certified by their employer or an accountant.

- **Sophisticated investors** - instead, business angels may have signed a certificate exempting them from the general restrictions on financial promotion in relation to certain categories of investments such as buying, selling or subscribing for securities and receiving advice on investments, if they can produce a statement from an authorised person stating that that person is sophisticated enough to understand the risks involved in that type of investment.

- **Associations of high net worth or sophisticated investors** - an exemption also exists in respect of certain communications (such as circulating a business plan) to associations of high net worth or sophisticated investors. This exemption is limited to situations where the investment is of a type which means that the person does not incur a liability to contribute more than he commits by way of investment, for example, a regular contribution to a business angel network.

Entrepreneurs should therefore check the status of any proposed business angel investors before communicating details of their investment proposition.

Misleading Statements

Section 397 of FSMA contains a general prohibition on the inclusion of misleading statements in documents that are designed to induce or persuade people to enter into investment agreements or to buy or sell shares in companies. This therefore applies to the business plan which entrepreneurs will be presenting to potential angel investors. Section 397 states that any person who makes a statement, promise or forecast or dishonestly conceals any material facts, or who recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive, is guilty of an offence if he makes the statement, etc. for the purpose of inducing (or is reckless as to whether it will induce) another person to enter or offer to enter into an investment agreement. Sanctions for a contravention of these provisions includes imprisonment up to seven years or a fine or both, therefore entrepreneurs should ensure they make every effort to verify the claims they make when marketing their business to potential investors to avoid breaching this provision.

N.B.

Please note that this is a complex area and the above guidance is no substitute for professional advice that relates to your specific circumstances. Entrepreneurs are advised to take legal advice at the outset of their fundraising exercise before making any communications (whether written or oral) with potential investors in order to ensure compliance with FSMA and other relevant legislation.

2.2 Heads of Terms

Once the entrepreneur has convinced angel investors of the merits of his proposal, he will receive a formal offer of investment that contains information on the terms of that investment in the form of a "Term Sheet". This is likely to use the format of the BBAA Term Sheet or similar. This is a non-binding offer to invest, although certain provisions will be legally effective as explained in **section 3** below.

2.3 Due Diligence

Having agreed the terms of the investment in principle using the Term Sheet, the angels will wish to undertake a more detailed review of the Company's activities in order to ensure the full extent of the Company's potential risk areas. From the perspective of the angels, the key areas for consideration are:

- **Financial / Tax -** is the financial information provided to the angels an accurate reflection of the Company's performance? Has the Company complied with its obligations under the applicable tax legislation?

- **Commercial / Market –** does the entrepreneur (and the angel) understand the Company's market and the factors which determine its future performance in those markets? Does the angel believe the market has the right characteristics to deliver the return on investment he is seeking?

- **Legal –** has the Company complied with the relevant legislation in conducting its business, for example, when employing staff, disposing of its waste and ensuring that any environmentally sensitive materials are appropriately dealt with? Are there any areas of the business that could cause problems in the future, for example, onerous indemnities given to customers and suppliers, or disgruntled employees with bona fide employment claims? Critically, does the Company own the key assets (for example, intellectual property) which are critical to its success?

2.4 Drafting / Negotiation of Documents

Once the due diligence investigation is underway and the initial tranche of information has been reviewed by the angel investors, the angels' lawyers will draft and circulate the documents required to transact the investment. The principal documents are:

2.4.1 **Shareholders' Agreement** - an agreement between all current and future shareholders of the Company that sets out the rights of the angel investors and the other shareholders, for example, matters requiring consent and information rights, and provisions such as warranties and restrictive covenants given by certain members of the existing management. These specific provisions are explained later in **section 4** below; and

2.4.2 **Articles of Association** - the key part of the Company's constitution that governs the running of the Company, setting out the voting rights of shareholders, how shareholders' and board meetings will be conducted, and important provisions such as good leaver / bad leaver, drag along and tag along, and share transfer mechanism. These specific provisions are explained later in **section 5**.

The BBAA and Eversheds have prepared specimen versions of each of these documents that reflect common practice in the business angel and entrepreneur community, and are designed to be even-handed to narrow the range of issues in contention.

The articles of association and shareholders' agreement will also need to be accompanied by various ancillary documents, such as board minutes and shareholder resolutions. These should be reviewed by the lawyers acting for both the Company and the angel investors to ensure the investment is transacted correctly.

Finally, depending on the findings of due diligence and the approach taken by the angel investors, the following additional documents may be prepared and circulated:

- **Disclosure Letter and Disclosure Bundle** - if the persons required to give warranties in the Shareholders' Agreement believe there to be any issues that are inconsistent with those warranties (for example, an item of litigation), they may bring this to the attention of the angel investors by way of a specific letter, known as the Disclosure Letter. This has the effect of qualifying the warranties and offers protection to the warrantors against a potential claim for breach of warranty. The Disclosure Letter may be accompanied by supporting documentation, for example, correspondence relating to the item of litigation, which is known as the Disclosure Bundle. The scope of the Disclosure Letter (and whether it is required) will depend on the nature of the warranties sought by the angel investors - if the management are only warranting that the business plan has been diligently prepared, for example, it is possible that no disclosures will be required.

- **Service Agreements -** as part of ensuring that the legal relationship between the entrepreneurs and the Company is clear, the angels are likely to require that new service agreements are entered into between key individuals and the Company at completion. These service agreements will contain important provisions such as restrictive covenants (see later), notice periods and grounds for dismissal, and the interaction of these provisions with the terms of the Shareholders' Agreement and Articles of Association needs to be considered carefully.

- **IP Transfer / Licence Agreements -** it is often the case that during the due diligence process, the angels discover that the intellectual property rights to a particular product are actually owned by the entrepreneurs in their individual capacities, rather than by the Company into which they are making their investment. This poses a risk to the angel investors, for if the entrepreneurs ceased their association with the Company for any reason, the Company's ability to exploit the particular product or service may no longer exist and therefore the value of their investment would be diminished. As a result, angels should require the transfer of all relevant intellectual property rights to the Company before completing their investment.

- **Share Option Scheme -** in order to align the interests of the employees of the Company with those of the current shareholders and the angel investors, the angels (or the entrepreneurs) may propose that, as part of the current fundraising process, an employee share option scheme is set up. This would operate by granting the participating employees an option to acquire shares in the Company at a certain point in the future (usually, an exit) for a price fixed at the date the option is granted. If the value of the shares has increased, as anticipated by the entrepreneurs and the angel investors, the employee will share in the upside by enjoying the benefit of the difference in value. There are various forms of share option scheme, some of which can be tax advantageous (provided that the Company and the employees meet the relevant legislative requirements). In particular, Enterprise Management Incentives ("EMI") options are commonly used. This is a technical area and specific advice on the taxation implications for the Company and the optionholder needs to be taken before selecting and adopting a scheme, although for present purposes it is sufficient to acknowledge that the scheme may either be adopted by the Company at completion of the investment, or shortly thereafter having laid the legal foundations for it to do so.

Before the investment can be transacted, the lawyers acting for the angel investors and the Company / the existing management will need to be happy with the form of the documents described above. In order to reach this point, it is likely that the document will go through a number of iterations as they are commented upon and amended by each party and their advisers, although progress is usually best achieved by face-to-face dialogue in order to agree points of principle first.

2.5 Timetable

It is difficult to be prescriptive as to the timetable of a typical angel investment due to the high number of variables involved, for example, the diligence requirements of the angel investors, the maturity of the Company and the nature of the angel investors, meaning that the dynamic of every deal is slightly different. However, on the basis that a fairly high level due diligence review is performed, one may expect the following example timetable to be not unrealistic:

Week 1	Company receives Term Sheet from angel investors.

Week 2	Company and angel investors agree Term Sheet and due diligence information is provided for review.
Week 3	Due diligence (financial / tax / commercial / market / legal) continues. Draft Shareholders' Agreement and Articles of Association circulated by the angels' lawyers.
Week 4	Shareholders' Agreement and Articles of Association commented upon by Company's lawyers. Any additional documents required (for example, service agreements, IP assignments) also circulated for review and agreement.
Week 5	Meetings and telephone conferences between the parties and their advisers to agree the terms of the investment documentation.
Week 6	Completion of investment - funds transferred to the Company and shares issued to the angels.

The fundraising process will be a challenging and intense period for both the entrepreneurs and the angel investors. In addition to their contribution to the process, the entrepreneurs will be heavily involved in the management of the Company during this time. It is important that entrepreneurs are prepared for this additional workload and have planned accordingly, for example, by delegating some management responsibilities to appropriate colleagues, so that the performance of the business is maintained whilst the fundraising process is ongoing.

2.6 Costs

The transaction of any equity investment is a technical legal area and both the angels and the Company / entrepreneurs need to obtain advice from lawyers experienced in such matters in order to ensure that that the investment documents reflect the terms of their agreement and provide the appropriate contractual protection. However, good legal advice can seem expensive (although it is much cheaper than bad legal advice!) and both entrepreneurs and angels will wish to ensure that the legal costs are kept under control and are not disproportionate when compared to the amount of money being raised. The following tips may assist in seeking to do so:

- Select advisers who are experienced in transacting early stage equity investments and have the resources to keep up with the process -

some entrepreneurs and angels default to their “relationship lawyers” who may have dealt with their house purchase, for example, and this can lead to delays in the timetable and unnecessarily aggressive terms being accepted.

- Encourage those advisers to adopt industry standard practice where appropriate to narrow the range of points that need to be negotiated, for example, using the BBAA legal precedents as the starting point.

- Agree a detailed scope of work and fee estimate, or preferably, a fixed fee, with your advisers at the outset.

- Ensure the process is as efficient as possible - ideally, have one all parties’ meeting with a specific and detailed agenda to run through all the points, rather than these emerging as various drafts as circulated, enabling your advisers to amend and agree the terms of the documents to reflect this. Do not commit to a completion meeting until the documents are finalised to your satisfaction - fees can increase dramatically if outstanding points need to be discussed, drafted and then agreed in a drawn-out completion process.

3. THE TERM SHEET

3.1 Introduction

The first document which is circulated between the angel investor(s) and the investee company is the term sheet, which will be drafted by the angel investors in order to summarise the key terms attaching to their offer of investment. As stated in the second paragraph, the majority of the terms of this document will not be legally binding as the detail will appear and be negotiated in the Shareholders' Agreement, Articles of Association and ancillary documentation. However, certain terms should be legally binding – these being those relating to Professional Fees, Exclusivity and Confidentiality (as noted below) – and these should be considered carefully before acceptance.

Given that a large part of the Term Sheet is expressed to be non-binding in this way, entrepreneurs and angel investors may be forgiven for questioning why the Term Sheet is used at all. Although all parties need to mindful to keep the Term Sheet relatively brief so as not to spend excessive time at this early stage, the benefits of using a Term Sheet are that it highlights key issues which require the focus of both of the parties (for example, leaver provisions and restrictive covenants), and also provide a "moral commitment" on both sides to observe the terms agreed in future negotiations.

The key terms of the BBAA Term Sheet are set out below:

3.2 Investment Summary (paragraph 2)

Those reviewing the Term Sheet will naturally focus on this key section, which sets out the amount of investment that is proposed and the number and class of shares to be issued, and therefore the angels' current valuation of the Company. Angels will typically subscribe for ordinary shares in the Company, meaning that such shares will attract the right to vote, receive a dividend if declared and participate in a winding-up of the Company. This has the benefit that such shares have the ability to attract EIS relief (as explained in **section 6**). Ordinary shares can be distinguished from other classes of shares such as preference shares, which typically give the holder the right to receive a fixed dividend from the Company and participate in a winding-up of the Company ahead of the ordinary shareholders. If the angels are investing together with an institutional investor such as a early stage venture capital fund, it is likely that such an institution will seek to subscribe for preferred shares.

Although the BBAA precedent states that the investment will be made in full at completion, some investors may seek to reduce their exposure by providing for the investment to be drawn down by the Company in instalments upon the achievement of certain milestones, for example, proof of concept or a certain sales threshold. This practice is known as "tranching" and the conditions relating to such investments will need to be considered carefully.

3.3 Conditions Precedent (paragraph 3)

The "Conditions Precedent" refer to each of the areas that the angel investors wish to address before proceeding to complete their investment, which are typically as follows:

3.3.1 Warranties

Having received information and representations from the Company during the due diligence process, the angels will want to ensure that the Company, and the entrepreneurs on whom they have relied, are seen to "stand behind" the information provided by giving warranties (legally binding statements) about the status of the Company and the quality of the information provided. These are often keenly focused on by entrepreneurs and angels alike since, if a warranty later proves to have been incorrect, the angels may have the ability to sue the entrepreneurs and the Company to recover the loss they have suffered in relying on such a warranty.

The presentation of the warranties will often depend on how the angels have conducted their due diligence exercise. If, for example, the angels have provided the entrepreneurs and the Company with a questionnaire to elicit information about the Company, the angels may elect to rely on a simple set of warranties that confirm that the responses to the questionnaire are true and accurate in all respects. However, if the angels have received information from a broader range of sources, for example, through correspondence with the Company's advisers, the angels may elect to set out a long-form set of warranties about the Company, covering the constitution of the Company itself, the financial information provided, the ownership of its intellectual property and a wide range of other key areas. The detail of these warranties will appear in the Shareholders' Agreement.

3.3.2 Transfer of IP

Please see above at **paragraph 2.4**.

3.3.3 EIS approval

From the angels' perspective, one of the attractions of investing in early stage businesses is that such investments often attract Enterprise Investment Scheme ("EIS") relief. Although not every angel will see EIS as a major benefit, entrepreneurs should be mindful that most angel investors will expect their investment to attract EIS relief and will require confirmation of this before completion.

3.3.4 **Service Agreements**

Please see above at **paragraph 2.4**.

3.3.5 **Keyman Insurance**

The angels' evaluation of the experience, expertise and ambition of the entrepreneurs leading the venture is critical to their decision to invest, and if one of these entrepreneurs were to die or suffer from an illness that meant they could not longer contribute to the venture, this could have a detrimental effect on the business. As a result, angels often require that the Company takes out "keyman" insurance to ensure that if such an event were to occur, the Company would receive an appropriate sum to mitigate the anticipated impact on its performance.

3.3.6 **Investor Director**

In order to monitor the health of their investment and assist in the growth the Company, the angels are likely to wish to appoint a director to the board of the Company. This is usually the "Lead Investor" (i.e. the angel who is co-ordinating the angel syndicate in respect of the investment).

3.4 **Shareholders' Agreement (paragraph 4)**

This clause is simply an acknowledgement, for the avoidance of doubt, that the terms of the investment will be governed by a Shareholders' Agreement that will provide for the following rights in favour of the angel investors, amongst others:

3.4.1 **Consent Matters**

The angels will seek to ensure that certain actions cannot be taken by the Company without their specific consent. These will include actions which clearly affect the value of the angels' investment, for example, the issue of additional shares or raising of loan finance, and may (depending on how hands-on the angels wish to be) include certain operational matters such as capital expenditure commitments.

3.4.2 **Information Rights**

Again, in order to monitor the financial health of their investment, angels will wish to receive appropriate financial information such as the statutory and management accounts of the Company, and other information they may deem important, for example, details of an approach to acquire the Company that is received by its board.

3.4.3 **Restrictive Covenants**

The angels will also wish to ensure that if the entrepreneurs have any other business interests, there is no element of conflict that could undermine the value of their investment, and further, if any of the entrepreneurs were to leave the Company, they would be restricted from using their detailed knowledge of the Company to diminish its ability to succeed, e.g. by setting up in competition or soliciting its employees. Such restrictions need to be considered carefully to ensure that they are legally enforceable, and do not prejudice the entrepreneurs' ability to earn a living if the partnership with the angels does not turn out as anticipated.

3.5 **Share Transfers (paragraph 5)**

Again, this clause highlights that the Articles of Association will contain the following terms, amongst others, that are commonly used when making equity investments:

3.5.1 **Good Leaver / Bad Leaver**

These provisions operate so that if a shareholder who is employed by the Company were to leave his employment during the period of the investment, such a shareholder would be required to offer his shares for sale. This is to avoid a situation whereby the remaining shareholders are working hard to build the value of the Company, yet in so doing are also enriching the "leaver" who is no longer making a contribution. This has the potential to demotivate the remaining management team and therefore "leaver" provisions are commonly required by angels. The value at which the leaver's shares are offered for sale will depend on the circumstances of their departure and are subject to considerable negotiation - a "good leaver", for example, someone who leaves through no fault of their own (e.g. due to ill health) may expect to receive fair value of their shares, conversely, a "bad leaver", for example, someone who resigns to join a competitor, may only receive the initial value of their investment.

3.5.2 **Drag Along / Tag Along**

Both entrepreneurs and angels will hope that they will receive an offer for their shares in the Company from a third party at some point, for example, a larger competitor or a private equity investor. Such an acquirer will wish to acquire the entire issued share capital of the

Company, and if the majority of the shareholders wish to sell, they will not want the transaction to be frustrated by the minority. A "drag along" right therefore sets out a procedure whereby a certain specified majority can force the minority to sell their shares to the proposed acquirer. In addition, to protect the interests of the minority, such a provision is generally accompanied by a "tag along" right that gives the minority the ability to demand that any offer for the shares held by a certain specified is also extended to the minority before completion of the acquisition.

3.6 **Composition of Board (paragraph 6)**

In order to monitor the performance of their investment in the Company and provide a forum of the angels to offer guidance as the Company grows, it is likely that they will wish to appoint one (or more) of their number to the board of directors of the Company. This is often the angel who is expected to be most "hands-on" in both the investment process and subsequent monitoring, known as the "lead investor". It is customary for the lead investor to receive a fee for providing these services, although the Company will no doubt wish to ensure this is reasonable when the financial position of the Company and the time commitment of the lead investor is taken into account.

It is also possible that the angel investors wish to alter the composition of the board of directors to position the Company for future growth. For example, it is not uncommon for early stage businesses to lack financial and accounting expertise, as the Company has understandably concentrated on developing its products and initial customer base. The angel investors will wish to ensure that the board has the right set of skills to take the business forward and this may involve the recruitment of additional directors ahead of completion.

3.7 **Professional Fees (paragraph 7)**

To ensure that the legal process delivers the objectives of each party, the following types of advice will be required:

- **the Company** - as the legal entity raising money, it will need to ensure that the appropriate corporate legal formalities are observed in creating and issuing shares to the angel investors;

- **the angel investors** - who will seek to implement a financing structure that enables them to achieve their financial objectives, whilst offering contractual protection to cover the downside;

- **the entrepreneurs / existing management** - as existing shareholders in the Company and as parties to the shareholders' agreement, the entrepreneurs will seek to ensure that the terms of the angels' investment do not unduly prejudice their ability to achieve their financial goals, whilst ensuring their personal exposure is reasonable in the circumstances.

The angel investors will seek to ensure that the Company's liability for its own professional costs is kept under control, whilst also ensuring that it is clear that the Company will need to pay their own costs from the gross sum invested (as a cost of raising the money). The Company will wish to ensure it has visibility of these costs and keep them to a reasonable level.

3.8 **Exclusivity (paragraph 9)**

Having decided to proceed past the Heads of Terms stage and spend time and professional fees on due diligence and the negotiation of the investment documents, the angel investors will expect the entrepreneurs to demonstrate commitment to the process by terminating their negotiations with other investors (if any) and undertake to exclusively negotiate with the angels for a set period. The timeframe will depend on the overall transaction timetable, although four weeks is generally considered to be appropriate. Entrepreneurs should note that this clause is specifically stated to be legally enforceable, with the sanction for breaching such an undertaking being the reimbursement of the angels' abortive costs and other expenses.

3.9 **Confidentiality (paragraph 10)**

Given the commercially sensitive nature of the discussions, it is important that details of the proposed investment are kept confidential to protect the interests of the Company, the angels and the entrepreneurs. This clause provides for a legally binding undertaking from all parties to keep information relating to the proposed investment confidential at all times.

4. SHAREHOLDERS' AGREEMENT

4.1 Introduction

It is hoped that the majority of the provisions of the Shareholders' Agreement and Articles of Association speak for themselves, and that when read with the detailed commentary on the additional commercial considerations provided in **section 3** (Term Sheet) of this note, gives a rounded understanding of the mechanics and issues surrounding a business angel investment.

The commentaries on the Shareholders' Agreement set out in this **section 4** and the Articles of Association set out in **section 5** do not seek to cover the items already glossed in the Term Sheet section, but rather highlight those more detailed areas covered in the Shareholders' Agreement and the Articles of Association respectively.

Between them, the Shareholders' Agreement and Articles of Association will incorporate the major commercial issues addressed by the Term Sheet but:

- will be legally binding upon the parties; and
- will be significantly more detailed.

The Shareholders' Agreement and the Articles of Association will also cover less fundamental issues which may or may not have been set out in the Term Sheet.

The Shareholders' Agreement has two main purposes:

- to document the angels' subscription for shares in the Company, and the terms upon which they will subscribe;
- to regulate the relationship between Managers, the angels and the other shareholders in the Company. As such, you may also see the Shareholders' Agreement referred to as "Investment Agreement" or a "Subscription Agreement". These three terms are broadly interchangeable and all refer to the contractual documents entered into by the parties in relation to the transaction.

4.2 Completion (Clause 3)

Generally speaking, angels will not want to commit themselves contractually to fund the Company until all of the conditions which they have specified in the Term Sheet are met, and the cash from them and from any other co-investors is immediately available. As such, they are unlikely to wish to exchange the Shareholders' Agreement and complete at a later date. Exchange and completion of the Shareholders' Agreement is almost always simultaneous. This is the basis upon which clause 3 has been drafted. If for any reason it is agreed that the Shareholders' Agreement be exchanged, and legally binding obligations created with completion to be at a later date, further provisions to provide for this will need to be included in the Shareholders' Agreement and you should take advice from your legal advisor as to the necessary provisions required.

4.3 Investor Director (Clause 8)

The Shareholders' Agreement provides for the appointment of an Investor Director by an Investor Majority. Angels will commonly wish to monitor their investment by way of a board director, who can also add their experience and expertise to the management set up. In the event that none of the angels wish to sit as a statutory director on the board of the investee company, or nominate a third party to do so, but nonetheless wish to monitor their investment with regular participation and exposure to board matters, the investors may require instead as or as well as an Investor Director, a board observer.

An observer usually has the right to receive all board papers and to attend and speak at board meetings. However, the observer would not be a full board director and therefore would not have the rights to vote on board resolutions. The observer would not however, have an obligation to abide by the directors' duties and obligations to which statutory directors are bound.

4.4 Sale or Listing (Clause 11)

Most investors will have an investment horizon after which time they would seek to realise the investment that they have made in the investee company and (hopefully) take their profit. It is increasingly usual for investors to provide for an undertaking to be given by management to assist them in achieving and exit within an agreed time period.

Five years, which is the time period suggested in the draft Shareholders' Agreement is a common investment horizon. However, angels should bear in mind that their investment may very well remain invested for a longer period since their funds may be followed by a subsequent fund raising from an institutional investor who will reset the investment horizon for the Company.

4.5 Remuneration Committee (Clause 13)

Remuneration Committees are becoming increasingly common even in smaller early stage businesses and are viewed as particularly useful forums for the discussion and determination of share option grants to existing and incoming managers. Less common, but also of use in more established, larger turnover companies is an Audit Committee which may comprise of the Chairman of the Board (if any), the Finance Director and an Investor Director. If an investee business is one which would benefit from the scrutiny of an Audit Committee then provisions to constitute an Audit Committee, similar to those constituting the Remuneration Committee may be added in the Shareholders' Agreement.

4.6 **Variation (Clause 22.5)**

Often companies need to go through another funding round prior to an exit. That funding round may need to be undertaken quickly, and certainly all participants will want to ensure that it is as painless a process as possible. Unless the shareholdings in the Company have been kept between a tight-knit base of angels and managers, absent or un-contactable shareholders can be a real problem if all shareholders are required to sign documents to effect the subsequent funding round. Recent changes to the Companies Act means that shareholder resolutions may now be passed in writing by shareholders holding between them 75% of the voting capital of the Company. This is clearly much easier to achieve than the former position where 100% of the shareholders' signatures was required.

However, a further funding round may very often require changes to or replacement of the Shareholders' Agreement. Without a specific provision as to how the existing Shareholders' Agreement is varied, 100% of the signatories to the original agreement would be required to amend or replace the agreement. For this reason, we have provided that the agreement may be varied by shareholders holding only 90% of the share capital of the Company. The 90% figure is not set in stone; it is a figure which can be agreed amongst the shareholders at the time of entering into the initial contract. However, shareholders with a significant shareholding may feel it inappropriate for a contract to which they are party to be varied potentially without their consent.

5. ARTICLES OF ASSOCIATION

5.1 Dividends (Article 4.1)

Few early stage businesses have a fixed dividend policy and in the early years of such businesses where the focus is more on research and development than sales, then there will simply not be the profits with which to declare a dividend in any event. Even where profits are available, reinvestment of such profits in R & D may be in the medium to long term interests of the Company and ultimately the shareholders rather than stripping that cash out by way of dividend. For these reasons, the rights to dividends as set out in the Articles of Association have been left as discretionary only. The key concern of all shareholders will be that if the board does agree to declare a dividend then such dividend is declared on all shares equally. In a company with only one class of share then this is automatically achieved. In companies which have split the share capital into different classes of share, consideration should be given as to whether a uniform dividend policy is adopted for each of those classes.

5.2 Allotment of Securities (Article 5)

Another area in which all shareholders are likely to be concerned is over the potential for their stake in the business to be diluted by a future issue of new shares, either to a third party or to one particular shareholder. As a protection against such dilution, Article 5 provides that no new shares may be issued by the Company unless the existing shareholders have the right to buy such shares first in proportion to their existing share holdings. Assuming that shareholders have the finance and the appetite to subscribe for more shares in the Company in the event of a pre-emptive offer, this means that such shareholders will be able to maintain their percentage shareholding in the Company through future funding rounds.

In addition, because of the consent rights in the Shareholders' Agreement, the angels also have the protection of knowing that no subsequent issues of shares may be made without their consent.

A common carve out to pre-emption rights is the issue of shares pursuant to the exercise of employee share options, as discussed earlier in this note. If a share option scheme is adopted, then to be workable it must operate outside the scope of pre-emption rights.

5.3 Voluntary Transfers (Article 8)

In addition to the pre-emption rights on the new issue of shares, shareholders also enjoy pre-emption rights on the transfer of shares by existing members. These pre-emption rights apply not only to voluntary transfers but also in the event that a shareholder is required to transfer their shares pursuant to compulsory transfer provisions.

6. THE ENTERPRISE INVESTMENT SCHEME ("EIS")

As outlined at **paragraph 3.3.3** above, most business angels will expect their investment to attract EIS relief and will require the Company to confirm that the Company and its business satisfy the EIS qualifying conditions before completion. The EIS rules are complex and it is important that the Company seeks professional advice on this aspect at an early stage to ensure the qualifying conditions are satisfied and to obtain a clearance to this effect from HM Revenue & Customs ("HMRC") - see below. What follows is a brief general guide only the EIS scheme and the tax reliefs available under current law (which is subject to change in future).

6.1 Tax relief for angels

If the conditions for EIS relief are met, the angels may be able to benefit from the types of relief outlined below. However, where EIS relief is available and is claimed by an angel, then income tax relief is not available in relation to interest payable by him on any money borrowed by him to enable him to make his investment in the Company.

6.1.1 Income tax relief

An individual angel may claim relief against income tax if they invest no less than £500 in acquiring new ordinary shares in an EIS qualifying company. The relief is given by deducting a sum equal to 20% of the amount invested from the angel's income tax liability for the tax year of the investment. Relief may be claimed in respect of EIS qualifying investments (in one or more companies) of up to £500,000 in any tax year. Therefore, the maximum reduction in his income tax liability for the tax year 2008/2009 is £100,000 if he invests the maximum £500,000 in that tax year and has an income tax liability of at least £100,000 in that tax year before taking account of the EIS relief.

6.1.2 Capital Gains Tax ("CGT") exemption and capital losses

The angel may also be entitled to exemption from CGT on the disposal of his shares in the Company, provided the investment limit of £500,000 is not exceeded. If the angel makes a loss on his shares then it may be possible to set an amount equal to such loss less the EIS income tax relief given as referred to at **paragraph 6.1.1** above against his income and thereby reduce his income tax liability for the year of disposal or the previous year instead of setting such loss against other capital gains realised by the angel. However, whether or not such CGT exemption or loss relief is available will depend on the circumstances and the tax law at the time of the disposal.

6.1.3 **CGT Deferral**

If the angel realises a capital gain on a disposal of another asset then if he reinvests the proceeds of the disposal in new ordinary shares of an EIS qualifying company, it may be possible to defer the CGT payable on such disposal until the EIS shares are sold or the requirements for EIS cease to be met.

6.1.4 **Inheritance Tax exemption**

EIS shares generally qualify for 100% business property relief once they have been held for two years and so long as the Company continues to be an unquoted trading company.

6.2 Restrictions on the Company's business

In certain circumstances EIS tax relief will be withdrawn or, in the case of the CGT exemption and loss relief, will not be available if the Company and its business does not continue to satisfy the EIS qualifying conditions for a specified period. The shareholders and directors of the Company (other than the angels) will be required to undertake to the angels in the Shareholders Agreement to ensure that the business of the Company continues to be conducted in such a way so as not to prejudice the availability or continued availability of the EIS tax relief. If such undertakings are breached then the angels may have a claim for compensation against the persons giving them for losses suffered by the angel if as a consequence any EIS tax relief is withdrawn or is not available. The other shareholders and directors should ensure that they fully understand the restrictive nature of these undertakings and their likely impact on the future development of the business: indeed the nature of these undertakings may, depending on the future plans in relation to the business, rule out raising funds from angels to whom the EIS tax reliefs are important.

6.3 Conditions for EIS relief

The rules for the availability of EIS relief are complex. The key conditions are outlined below.

6.3.1 **Conditions relating to an angel**

- The angel's shares in the company must be acquired for genuine commercial reasons and not for tax avoidance purposes;

- the shares must be held for at least 3 years;
- the angel cannot hold a stake in the company of more than 30%. For these purposes, the holdings of the angel's relatives and business partners are added to his own;
- although the angel may become a director of the Company, EIS relief is not available if the angel was previously connected with the Company as an employee or paid director or was involved in carrying on the whole or any part of the trade of the Company. If the angel is to become a director then particular care is required to ensure that the arrangements do not disqualify him or the Company for EIS purposes and professional advice should be sought.

The angel may lose part or full relief if they dispose of the shares within 3 years or if the angels receive value (other than value which is insignificant) from the Company.

6.3.2 **Conditions relating to the Company and its business**

- The gross assets of the Company must not exceed £7 million immediately before the shares are issued and £8 million immediately afterwards;
- the Company must be unquoted (but may be admitted to AIM);
- the Company must have fewer than 50 full-time employees (or part-time equivalent);
- the Company cannot raise more than £2 million in total over a 12 month period under the EIS scheme, the Corporate Venturing Scheme and the Venture Capital Trust scheme;
- the Company must carry on or be preparing to carry on (and within a specified period thereafter actually carry on) a "qualifying" trade. Most trades are qualifying trades provided they are conducted on a commercial basis with a view to making profits. Examples of excluded trades are: dealing in land, shares or commodities; property development; farming; hotels; nursing homes; financial activities; leasing; receiving royalties and licence fees; shipbuilding and coal and steel trades;

- the Company must carry on a qualifying trade for a specified period (normally 3 years) from the issue of the EIS shares;

- the Company must not be a 51% subsidiary of another company at the time the shares are issued or be under the control of another company and there must be no arrangements in place which may result in this condition not being satisfied;

- the Company must not control any other company other than a qualifying subsidiary;

- the shares must be issued by the Company in order to raise money for the purposes of the qualifying trade; for genuine commercial reasons and not for tax avoidance purposes;

- the money raised by the issue of the EIS shares must be employed for the purposes of the qualifying trade (an insignificant amount can be used for any other purpose); and at least 80% of the money raised by the issue of the EIS shares must be employed in such trade within 12 months and any amount remaining must be used in the trade within the following 12 months;

The Company will be subject of ongoing review by HMRC until, broadly, 3 years after the EIS shares are issued.

6.4 **Procedure for EIS clearance from HM Revenue and Customs**

6.4.1 **Advance assurance**

Generally, the Company will apply for clearance before the investment is made to ensure that EIS relief will be available. The application is sent to HMRC Small Company Enterprise Centre providing it with all relevant information in order the prove that the conditions above are met. HMRC may take between 15 and 30 working days to reply.

6.4.2 **Formal approval and issue of EIS certificates**

After the shares are issued, the Company will send a completed "compliance statement" on Form EIS 1 to HMRC Small Company Enterprise Centre. If HMRC is satisfied that all the EIS conditions are satisfied then it will authorise the Company on Form EIS2 to issue compliance certificates (EIS3) to the relevant EIS investors. The

Company will then issue EIS3 certificates to the angels enabling them to make claims for relief in their self-assessment tax returns.