FARRER&Co

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A basic guide to the legal process:

Investment

Introduction

Investment appeals to businesses for a wide range of reasons. For investors, it presents the opportunity to secure a return on capital in a tax efficient manner. For investee companies, it is primarily a fundraising mechanism, and can also provide access to external expertise and support.

"Investment" can encompass a broad range of activities. This guide focuses on equity investment, meaning a subscription for or purchase of shares in a company. It aims to address the following:

- advantages of investment;
- types of investor;
- stages of investment;
- key investment documentation;
- ancillary documentation and timeline; and
- key commercial terms.

This guide is intended to outline the main legal principles that any party entering into an investment will need to consider. Specific advice should be taken when structuring, documenting and implementing an investment to ensure that the commercial, legal, regulatory and tax objectives of the relevant parties are met.

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We use them for everything and think there is no better alternative. They understand their clients incredibly well.

- Client quote, Chambers UK, 2019

1. Advantages of investment

Parties seek investment for a number of reasons:

For investees

Fundraising

Companies typically seek investment to raise cash to fund working capital requirements and growth. Borrowing can be problematic because of the accompanying requirement to make regular interest payments, putting pressure on a company's cashflow. By contrast, raising equity finance can give a company more freedom to reinvest excess cash in the business or pay dividends to shareholders.

Access to external expertise

Securing external investment can give companies access to the expertise, experience and contacts of third-party investors, whilst incentivising those investors to provide that support. It can also enhance an investee company's credibility, helping it to build a stronger network and secure future investment.

For investors

Generation of returns

Investors generally invest to achieve a return on capital. Different types of investors will seek different types of return (and accordingly, make different types of investment). For example, a private individual may seek to invest in a diverse portfolio of assets to generate long term retirement income. A private equity fund, on the other hand, may invest with a five-year exit strategy, in the interests of generating shorter term returns for its shareholders.

Tax planning

Investment can, in some circumstances, enable investors to take advantage of certain tax reliefs, such as EIS and/or SEIS. The availability of these will vary depending on the particular circumstances of an investor and investment, and investors will need to take specific tax advice to ensure their investments are structured in a tax efficient manner.

2. Types of investor

1. Friends and family
Initial investors are often individuals with a close personal connection to a founder / investee. They will typically provide the founder with their first capital through relatively small investments in exchange for small portions of equity.

2. Angel investors
These are high net worth individuals or small investment-focused entities with experience in investing in early-stage companies which have already built a product.

3. Venture capital trusts
These are publicly traded companies listed on the London Stock Exchange which invest in early stage unquoted companies through pooled investor money.

4. Venture capital funds
These invest pooled investor money to provide financial and operational expertise for early stage, innovative businesses with strong growth potential.

5. Private equity funds
These are investment management companies which make large investments in companies through a variety of investment strategies including leveraged buyouts.

Whilst this guide focuses on equity investment, a brief comparison between equity and debt is set out below.

Equity: An equity investment is a subscription for, or acquisition of shares in a company. An equity investor provides the investee company with cash and receives an ownership stake in return.

Debt: A debt investment involves the lending of funds to an investee company at an agreed rate of interest, usually repayable in instalments during a specified period.

3. Stages of investment

The **stages of equity investment** into a company typically follow the following:

Seed
This is the first round of external funding that a business seeks, to help meet its initial start-up costs. The investor base tends to comprise angel investors (high net worth private individuals) and venture capital funds, and may also include founders' family members and friends. Founders tend to retain majority stakes at this stage, and third party investors typically take minority shareholdings.

Series A
Once it has a more established track record and business model, a company may opt for Series A funding to continue to grow its business. Angel investors and venture capital firms typically dominate these rounds, taking minority stakes and seeking certain investor protections in the investment documentation.

Series B
While seed and Series A funding is used by companies to meet initial set up costs and support early stage growth, Series B funding is typically sought to fund further expansion. Again, series B fundraisings tend to involve minority investments. The terms of the investment documentation may be varied at this stage to include additional minority protections, depending on the requirements of any new investors coming in.

Private equity
Private equity funds typically acquire stakes in much later stage companies. As these funds' returns are generally based on their ability to improve a business's performance and sell it on for a profit, they tend to take controlling stakes in a company and leave founders with minority shareholdings (if anything).

4. Key investment documents

The following key documents are typically involved in the implementation of an investment:

Confidentiality agreement
Before any substantial negotiations take place, the parties will enter into a confidentiality agreement. This prohibits them from sharing the information they provide to one another relating to the investment with third parties.

Information memorandum
Investee companies will typically prepare a presentation for investors about the company, containing material information about the company's business, operations, finances, capital structure and future plans. Companies will need to seek specialist regulatory advice before sharing any information with investors to ensure that they do so in compliance with all applicable regulatory obligations.

Term sheet
As a first step, the parties will agree the main terms and conditions of the investment in a term sheet. This will serve as a basis for the subsequent negotiation of full form documentation and tends not to be legally binding. It may, however, contain some legally binding provisions, such as an obligation for the investee company to negotiate exclusively with the investor for a certain period.

Articles of association
These govern the internal affairs of a company and function as a contract between the company and its shareholders. They are publicly available at Companies House and set out details of the rights attaching to shares issued by the company and related governance information.

Shareholders' agreement
This is an agreement between the shareholders of a company regulating the relationship between them. The company is usually also a party. Unlike a company's Articles, it is a private document and does not need to be publicly filed. It is therefore typically used to record personal, confidential or sensitive agreements reached between shareholders. Shareholders' agreements often deal with matters such as investor decision-making, shareholder consent rights and the protection of minority shareholders.

Subscription/investment agreement
This is the mechanical agreement by which an investor agrees to subscribe for shares in a company for a particular subscription price, and the company agrees to issue those shares to it. It also usually contains warranties given by the company and its founders or managers to investors about the state of the business and the potential investment.

Disclosure letter
If the company and/or its managers have given warranties to investors in the investment documentation, they may wish to provide a disclosure letter to investors to accompany these. This letter gives the warrantors the opportunity to disclose any matter which might render any warranty untrue (and thereby avoid liability for claims for breach of warranty in respect of such matters after the investment completes).

W&I insurance policy
Investors and / or warrantors may wish to insure the warranties under a warranty and indemnity insurance policy, to protect one or both parties in the event of a breach of warranty. The appropriateness of such a policy will need to be considered on a case by case basis. A warranty and indemnity insurance broker will typically assist with this aspect of an investment transaction, liaising with lawyers and insurers to negotiate an appropriate policy for the deal.

5. Ancillary documentation

In addition to the key documents listed, a suite of supporting documents will be required to implement the investment:

Shareholder approvals

Certain approvals may be required from the target company's existing shareholders. For example, existing shareholders may need to give the directors of the company authority to issue new shares to investors, or to waive their pre-emption rights in respect of the proposed share issue, or to approve the company's adoption of new articles of association. Certain other shareholder consents may also be required under the company's existing investment documentation.

Board approvals

The directors of an investee company will generally need to approve and authorise the company's entry into the investment documentation and issuance of shares pursuant to it, among other matters. This is typically done by a board meeting or directors' written resolutions. The company's existing articles of association should be checked to ensure the right approach is adopted. If the investor is a company, it may also need to secure certain approvals to enter into the relevant documentation and subscribe for shares under it. This will need to be checked and confirmed on a case by case basis.

Service agreements

Investors may ask founders and senior management team members who do not already have service agreements with the company to enter into these on or before the investment completes. Service agreements help to ensure that key members of the company's management team continue to contribute to the success of the company. They also tie into the good leaver / bad leaver provisions in the investment documentation (as discussed below).

Administrative filings

Once the investment has been completed, the company will need to update its register of members, issue share certificates to the new investors and make any appropriate filings at Companies House. These include, among other items, any special resolutions passed by shareholders in connection with the investment, a copy of the new articles of association of the company (if adopted) and a form SH01 which indicates that shares have been allotted in the company.

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> Excellent market knowledge, very commercial, pragmatic and practical advice.
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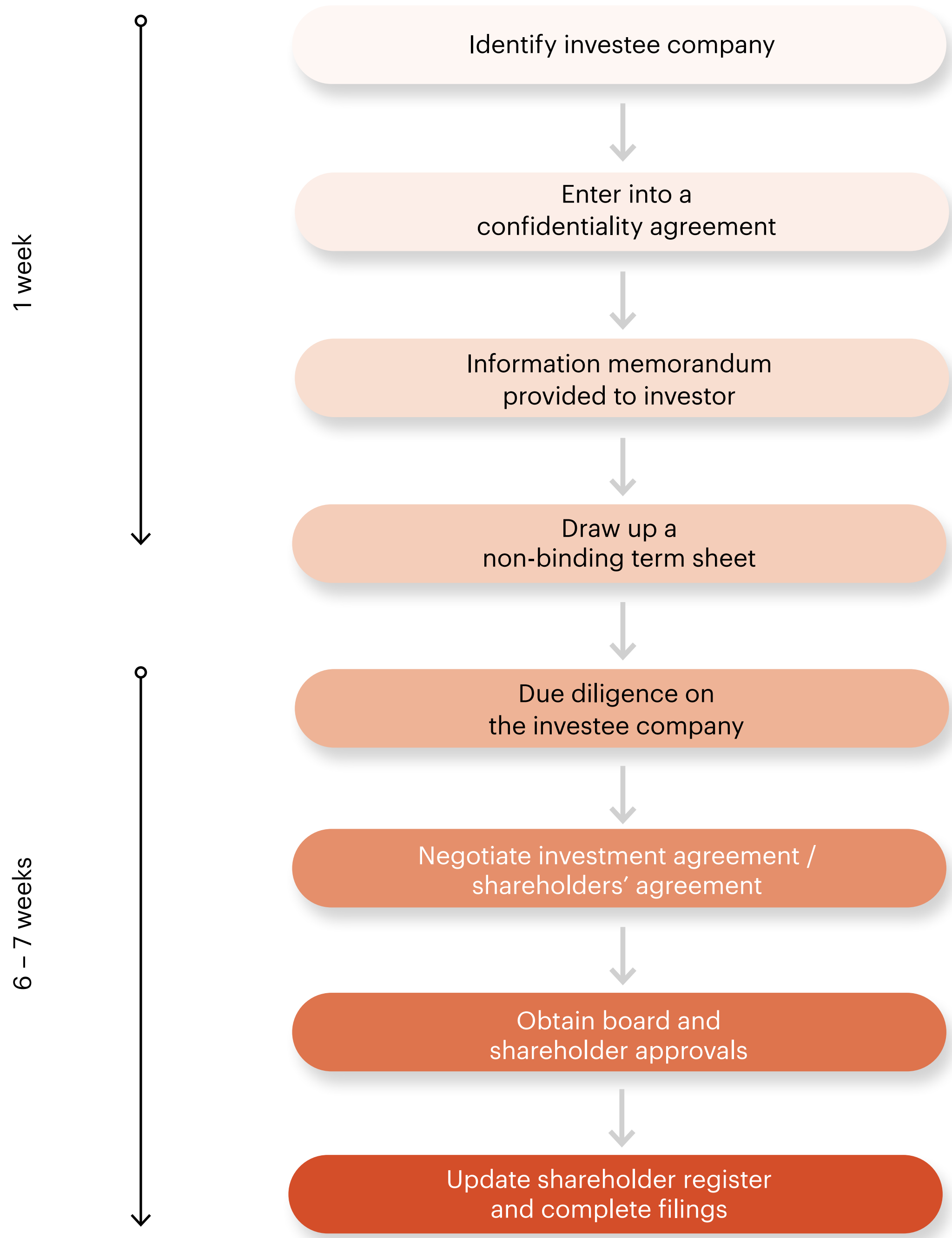
> - Corporate M&A, Legal 500 2020

6. Timeline

Investments can be implemented in a very short timeframe or take months to complete. This will depend on the number of investors involved, the complexity of their interests and the terms on which they are seeking to invest, and the willingness of all parties to work cooperatively to achieve their goals.

A typical investment might take eight weeks from the start of discussions to completion. An indicative timeline is as follows:



7. Key commercial terms

Investment documentation will typically cover the following key terms:

Board composition

The board of directors of an investee company will normally comprise senior executives including the CEO and CFO. Investors may seek the right to appoint a director to the board. Whilst larger shareholders typically can successfully negotiate this right, minority shareholders may instead be given a right to appoint an observer to the board (or nothing at all). It is also not uncommon to see investors being given rights to appoint a director or observer for as long as they hold a certain percentage of the company.

Investor consent rights

Investors will be keen to negotiate rights which prevent managers and/or other shareholders making key decisions about future fundraisings and/or the operation of the business without their consent. Investors may seek veto rights, whereby their consent is required for certain key decisions. Alternatively, they may seek to include a requirement that the company does not take certain actions without the consent of a specified majority of investors. A company will generally want to retain as much decision-making flexibility as possible, and be conscious of the administrative burden of having to obtain shareholder consents for decisions. This aspect of investment documentation is therefore often heavily negotiated to ensure the balance of interests is properly addressed.

Pre-emption rights

When companies issue new shares to incoming investors, the holdings of existing shareholders are diluted and as a result become less valuable. Shareholders therefore typically seek a right to subscribe for new shares pro rata to their existing shareholdings before the company offers them to new investors. Although these rights do exist under the Companies Act 2006, the statutorily prescribed procedures can be burdensome to comply with, so parties will often seek to disapply them and replace them with bespoke provisions in the investee company's articles.

Drag provisions

These provide that, if a certain percentage of a company's shareholders agree to a sale, the remaining shareholders can be dragged into the sale and forced to sell their shares on the same terms and conditions. The threshold at which drag rights will be triggered is negotiated between the shareholders, but is usually set at a level which represents a change of control of the company.

Tag provisions

These provide that, if a certain percentage of a company's shareholders agree to a sale, the remaining shareholders can tag along with them and sell their shares on the same terms and conditions. The threshold at which tag rights will be triggered is negotiated between the shareholders, but is usually set at a level which represents a change of control of the company. Tagging shareholders may be given the right to transfer all or a pro rata proportion of their shares to the relevant buyer.

Transfer restrictions

Investors and companies will generally seek to restrict shareholders' rights to transfer shares to third parties. Often, share transfers will be subject to investor consent, or to pre-emption rights in respect of existing shareholders. Certain limited transfers to, for example, members of a shareholders' family or corporate group, may be permitted without restriction.

Leaver provisions

These generally provide that, if an employee shareholder leaves the company, the company (or its shareholders) can acquire their shares back from them at a pre-agreed price. If the employee shareholder leaves for a "good" reason (e.g., death, incapacity or redundancy) they will usually be entitled to sell their shares for the higher of cost price and fair market value. If, however, the employee shareholder leaves for a "bad" reason (e.g., resignation or misconduct), they will be required to sell their shares for the lower of cost price and fair market value. An employees' shares may also be subject to vesting provisions, whereby his or her shares only become valuable after completion of a certain period of employment.

8. Conclusions

This guide is only a summary of the key steps involved in implementing an investment. Making or receiving an investment can be relatively straightforward, but there are many potential pitfalls which parties will need to be aware of as they progress through the process.

Specific legal, tax, accounting, financial and regulatory input should all be sought at an early stage, to ensure that all parties are appropriately advised and protected.

Farrer & Co's Corporate team regularly acts for private investors, venture capital funds, private equity firms, family investment offices and investee companies on all aspects of investment. We would welcome the opportunity to discuss any aspect of this guide with you.

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10. Glossary

Ancillaries	an umbrella term for supporting documentation such as board minutes, shareholder resolutions, stock transfer forms and Companies House filings that are required to effect a transaction
Articles of association	a document governing the internal affairs of a company
Confidentiality agreement	a legally binding contract between parties to an agreement preventing either party from sharing the information they provide to one another with third parties
Disclosure letter	a letter given by the investee company / managers disclosing matters that would make any warranties untrue
Drag-along provisions	a provision enabling a majority shareholder to force a minority shareholder to join in the sale of a company
Good and bad leaver provisions	provisions incentivising key executives to stay with the company and deterring them from leaving the company and/or to protect shareholder value from non-performers
Pre-emption rights	provide existing shareholders with the right to buy newly issued or transferred shares in the company before the shares are offered to the general public
Seed	first official equity funding stage used to help companies finance market research and product development
Series A	first external (other than friends and family of the founder) equity funding stage used to help companies develop their product and hire employees
Series B	second external equity funding stage used to help companies to scale their operations and move towards generating a profit
Shareholders' agreement	a private agreement entered into between all or some of the shareholders in a company regulating the relationship between them
Subscription/ investment agreement	an agreement dealing with the subscription for shares by the investors in return for the investment monies
Tag-along provisions	a provision enabling a minority shareholder to have his shares bought on the same terms as majority shareholders
Term sheet	a (largely non-binding) document setting out the key terms of the proposed transaction
Warranty & indemnity insurance policy	an insurance policy providing cover for losses arising from a breach of warranty

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