



Business Angel Finance: The Legal Issues



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Introduction

This Fact Sheet is concerned with finance provided by individuals to start-up and early stage companies. It considers the issues from the perspective of both the investor or 'business angel' and the entrepreneur whose company is seeking funds.

There is a significant legal challenge with investments of this sort as it is often the case that the investor and the company do not have the legal budget or the time to prepare and negotiate lengthy legal agreements. Business angels and entrepreneurs understandably are often tempted to "do it themselves". Alternatively they may prepare the initial draft and ask their adviser (who may not be legally trained) to check it briefly.

In fact, if both parties are prepared to be pragmatic and their advisers help them to focus on the key issues there is no reason why small investments cannot be made with adequate and sensibly priced legal documentation. This Fact Sheet explains how this can be achieved. A preliminary point to address is the Financial Services legislation and the prospectus regime for funds being raised by a share issue to the public.

1. Financial Promotion Regime

Entrepreneurs looking for investment should be aware of restrictions in the Financial Services and Markets Act 2000. This contains a prohibition on the circulation of *financial promotions*, that is to say any invitation or solicitation to a person to invest in your company. Breach of the prohibition is a criminal offence and could give the investor the right to compensation.

One route to avoid breach of the prohibition is for a "regulated person" (e.g. a corporate finance adviser) to approve the information memorandum or offer document. Under FSA Conduct of Business rules the adviser must satisfy himself that the document fairly presents the investment and its risks. The need for the document to be carefully checked, opinions scrutinised as appropriate and facts verified, means this exercise will be a costly one.

The preferred approach for a small fund raising is to seek investment from self-certified high net worth investors. That is someone who has, in the past 12 months, signed an appropriate certificate that his financial circumstances meet certain requirements. These are that he has £100,000 of income or else £250,000 of capital excluding his home and pension. Financial promotions to self-certified high net worth investors are not prohibited.

In addition to this certificate (which must be in a prescribed form) there must be a "health warning" (again in prescribed form) on the front cover of any relevant marketing materials, typically an information memorandum.

This process needs to be followed from the beginning of the fundraising to be legally effective: that is to say the first time that a document is issued that could be construed as an invitation or solicitation to invest.

Where preliminary material is circulated that does not contain a firm proposal as to an investment there may be an argument that the prohibition does not apply. The better approach, though, is to seek a self certificate and give the health warnings on day one.

There is another provision in the 2000 Act that should be remembered: section 397. This makes it a criminal offence to make reckless statements or promises or dishonestly to conceal material facts in relation to a proposed investment. Entrepreneurs need to bear this in mind even where the investor has chosen not to undertake due diligence or not to seek warranty protection.

A key issue may be whether there is a minimum sum that must be raised if the fund raising is to proceed. The minimum subscription level is a key investor protection where funds are being raised by public issue with a prospectus. Entrepreneurs and their advisers should apply their minds to this question. To take say £100,000 from one or two angels when £200,000 is really what is needed may leave the company hopelessly underfunded and unable to achieve the necessary

"milestone" to raise further equity.

2. Public Issues

A company seeking funds by a publicly available share issue must prepare a prospectus and file it with Companies House after it has been approved by the Financial Services Authority as regulator. Public share issues are typically undertaken when the shares of a company are to be admitted to trading on a market such as the Alternative Investment Market or the Official List.

Preparing a prospectus can be an onerous and time consuming exercise. The prospectus must include prescribed information as to the business, its financial performance and its management. Directors and advisers will want to ensure that the document is carefully verified so as not to mislead investors.

A prospectus is not legally required if the funds raised are less than €2.5 million or if it is to be sent to less than 100 prospective investors. This rule may mean it is prudent to number private placing memorandum to ensure the limit is not indirectly breached.

3. Simplicity

A start-up or early stage company will generally be high risk. Often it will require a number of funding rounds. That being so there is usually no place or need for "clever" financing techniques: plain vanilla is what is needed.

So what techniques should be avoided? Firstly, anything that avoids coming to grips with the valuation of the target company. These could include a ratchet or option which aims to reallocate equity depending on future performance including the value of future funding rounds. Such provisions will increase the complexity and legal cost of the documentation dramatically.

Secondly the use of different classes of ordinary share: although sometimes the use of preference shares (a hybrid between debt and equity) can be useful. Different classes of ordinary share, however, can lead to complicated legal drafting and may create unexpected legal results.

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The investor who wants to give himself a future strong negotiating position should bargain for a portion of his investment to go in as a debt rather than shares. He may also wish to secure that debt with a debenture or other available security (e.g a chattel mortgage)

The well-advised entrepreneur will usually prefer the investment to be all in ordinary shares. If he concedes that some will take the form of debt, he will want to avoid onerous repayment triggers and not concede security as this may rule out other credit lines (e.g a bank overdraft or asset finance).

4. Achieving Simplicity

Simplicity is achieved by the use of an experienced adviser who can guide both parties through the key commercial and financial "what ifs" and help them structure a balanced and fair position.

That position should then be written down on a simple one page (non-legally binding) term sheet that both parties sign. The lawyer(s) (and preferably just one lawyer) can then document that term sheet.

5. Term Sheet or Offer Letter

So what points should be included in a term sheet or offer letter? The following are key issues:

- the proportion of the enlarged share capital that is to be subscribed (often a spreadsheet showing the pre and post investment capital will be helpful).
- the amount to be invested and whether it is for shares only or shares and loans. If loans what are the terms?
- what the money is to be used for.
- what pre-conditions there are to the investment (e.g financial or legal due diligence).
- the basis upon which the investment is to be made: a business plan with a financial projection and an opening balance sheet will be important.
- whether the investor is to join the Board and if so on what terms.

6. Legal Documentation

At its simplest legal documentation can

comprise:-

- a simple subscription letter which includes key warranties
- Articles of Association which give a minimum protection for the investors.

For small investments it is generally best to avoid long and elaborate Subscription and Shareholders' Agreements.

Subscription Letter

There are a small number of fundamental issues that the prudent investor will want to know are correct and on which he will seek warranties on. These are:

- that the issued share capital is as it is presented (he will be well advised to have his lawyers check the statutory books);
- that the business plan has been carefully prepared, the facts stated in the plan are true and the opinions are honestly held;
- he will want to be assured that the key assumptions to the financial projections are believed to be true and reasonable;
- where relevant, ownership of intellectual property needs to be confirmed and that third party rights are not infringed;
- sight of a recent set of management accounts including a balance sheet;
- the terms of employment of the management.

Articles of Association

The Articles can be used to set out minority protection matters: so matters that would usually be decided by the Board can be specified as requiring approval by the holders of a certain fixed percentage of the share capital. That percentage will be set so that the consent of the investor is required for such matters. These matters may include changes to the remuneration of the management team.

The investor may also seek protection through an Article that specifies that new shares must first be offered to existing shareholders as a rights issue (a so called new issue pre-emption).

The investor may want to insist that his shares will give him the right to

nominate a Director.

For both parties pre-emption rights on share transfers (i.e rights of first refusal) may be important. For the entrepreneur and his team, an obligation to sell their shares if they leave the company will require careful thought. Generally, such obligations are inappropriate in a start-up.

The well-advised entrepreneur will likely want a suitable drag along article: this allows shareholders who hold a specified agreed percentage of the shares, and who decide to sell to a third party, to require all other shareholders to sell at the same price. This effectively allows the entrepreneur and his team to control the timing of any exit. Depending on the percentage trigger the investor may agree this but subject to a minimum price for his shares.

Conclusion

Structuring start-up and early stage investments and the associated legal documentation requires experienced and practical advisers. Early advice can save time and costs.

For further reading please see the following Everyman Fact Sheets:

- Shareholders' Agreement: Do I need one?
- Business Angel Investment Pack

everyman legal fact sheet

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