



HIPSTERS, HACKERS AND HUSTLERS EARLY STAGE INVESTMENTS: SEED CAPITAL WHAT TO EXPECT





INTRODUCTION

This guide provides a whistle-stop tour of seed capital investments for Hipsters, Hackers and Hustlers. It examines the process and key legal documents involved in such investments.

ABOUT WATERFRONT



Before we get on to that, a little about Waterfront Solicitors LLP, who we are and why we are here.

Over the years, lawyers have been fixed with a bad reputation, summed up by the idea that “no” is a lawyer’s favourite word. So much so that some think the legal profession is all about crushing the passion and spirit of entrepreneurs with a dry insistence on enforcing complicated rules and guidelines.

We think a little bit differently.

We understand the challenges that start-ups face. We’ve experienced many of them ourselves, as Waterfront was a start-up not so long ago.

We were founded in 2002 with a rather particular aim, to be a law firm for the tech sector. Over a decade later, we are still pursuing that vision. We now have clients who are household names in sectors as diverse as fashion to financial software, such as H&M and CMC Markets. That doesn’t detract from our core focus on technology, and more than that, on start-ups and entrepreneurs.

Our journey over the past 13 years has shown us that while businesses do need expert legal knowledge, they also want commercial nous and practical help, which doesn’t cost the earth. One of the best things about our role has been to grow side by side with our clients. As cheesy as it might sound, our aim is to be (and for our clients to feel that we are) part of our clients’ teams.

Alongside our sponsorship of Hipsters, Hackers and Hustlers events in February, March and April 2015, we have produced a three part series on key legal issues for start ups. In February Chloe Taylor covered intellectual property, in March Alison covered commercial contracts, and this guide focuses on seed capital investments. These guides may not answer every legal question that you’ll ever have. But they will help if you’re trying to set up and grow your business and you want to understand more about the law.

We’d love to have your feedback and suggestions on anything else we should include. You’ll find more information and our contact details at www.waterfrontsolicitors.com/hhh.

Finally, if you have any questions that you think we can answer, just pick up the phone and give us a call, we’re always happy to talk.

Matt Cunningham
Partner, Corporate Law



WHAT IS SEED CAPITAL?

Private companies often go through a number of investment rounds during the course of their development. This guide is only concerned with the very early stage investment rounds, known as seed capital rounds. It does not cover the larger and more complex venture capital investment rounds called series A rounds, or other types of investments such as strategic investments by larger competitors.

Seed investments are very early stage investments. They are usually made by private investors, including friends and family of the founders, business angels (i.e. high net worth individuals who invest in start-ups and early stage companies) and more recently individuals investing through crowdfunding platforms.

A seed investment typically involves one or more individuals investing up to £1m in return for an equity stake in the investee company. The companies receiving seed investments are usually at a very early stage in their development. They are often pre-revenue (i.e. they are not yet generating any income) and the money invested is generally used for research and development.

Business angels who are tax resident in the UK will usually want to invest under the Seed Enterprise Invest Scheme (SEIS) or the Enterprise Invest Scheme (EIS). These schemes provide private investors with income and capital gains tax reliefs and were introduced to incentivise high net worth individuals to invest in high risk/ high growth companies. Investments made under SEIS or EIS must comply with the relevant scheme's rules, which means that to an extent the terms and process of such investments are dictated to the parties. For example, the shares acquired by the investor must be full-risk ordinary shares that do not carry preferential rights to the company's assets in the event of a winding up.



INVESTMENT PROCESS

Introduction

The investment process varies greatly depending on the type of investors involved and the size of the investment made. Friends and family may be willing to invest entirely on the basis of trust and not be interested in doing any due diligence or require any contractual protection. Business angels may also adopt an informal approach where the amount they are investing is relatively small. They will understandably be reluctant to incur professional fees that are disproportionate to the size of the investment made, preferring instead to rely on SEIS/EIS tax reliefs to reduce the overall risk of the investment.

By contrast, business angels investing substantial sums are likely to take a more formal approach. They are likely to want to do at least some due diligence on your company and its business and they will undoubtedly require contractual protection in the form of warranties and minority shareholder rights.

Term sheet

Once you have agreed the key terms of the proposed investment with your investors it is advisable to summarise those terms in writing and (preferably) have all interested parties sign the term sheet. The desire to keep costs down and complete investments as quickly as possible sometimes results in the parties deciding to skip the term sheet and move straight on to due diligence. However, entering into a term sheet is a good idea for two reasons. First, although term sheets are generally not legally binding they are (to some extent at least) morally binding because it is more difficult for a party to renege on/ try to renegotiate an agreed term later on if it is clearly set out in writing. Second, term sheets help to ensure that the parties have agreed at least some level of detail (and not principles only) and do not waste time and money by proceeding with due diligence and contract negotiations where there are fundamental issues that cannot be resolved. After all, the devil is in the detail!

Due diligence

Due diligence is the process of investigation and appraisal of your company and its business by the investors and their advisers to establish the company's assets and liabilities and evaluate its commercial potential. In a perfect world due diligence should only commence after the parties have entered into a term sheet and (preferable) a confidentiality agreement, but in practice the investment process is often less structured than the parties' lawyers might like. It is not usual for due diligence to commence before terms have been agreed.

The nature and scope of due diligence varies greatly depending on the type of investors involved, the size of the investment and the company's stage of development. It is often the case with seed capital investments that very little due diligence is done since the investee companies are normally at a very early stage in their development and have little or no significant trading history.

Due diligence usually falls into three categories:

- Financial due diligence
- Legal due diligence
- Technical due diligence

Legal due diligence will usually involve you completing one or more questionnaires prepared by the investors and their advisers and providing copies of contracts and other documents.



Contract negotiation

The key legal documents are the investment agreement, the new articles of association and the disclosure letter. It is common practice for the investors' lawyers to prepare the draft investment agreement and new articles of association since it is the investors who may need to rely on the contractual protections contained therein. However, where the investors are friends and family and/or the amount being invested is relatively small the investors may be willing to let your lawyer draft the documents. If you are given the choice I strongly recommend you opt to have your lawyer draft the documents. The advantage of having "control" over the investment documents should not be underestimated and the difference in the professional fees payable is unlikely to be significant, particularly where the company is paying some or all of the investors' professional fees as well.

There will inevitably be some back and forth over the finer details of the investment documents (particularly where both sides have instructed lawyers). The length of the negotiations (and amount of legal fees payable) usually depends on the complexity of the documentation (which in turn depends on the complexity of the terms of the investment) and the number of parties involved. The more complex the documentation and the greater the number of parties involved the lengthier the negotiations are likely to be. It pays best to keep things simple (particularly where the amount being invested is relatively small)!

Disclosure

It is common practice for business angels to require warranties about the investee company, its business and its assets and liabilities. A warranty is a contractual statement about a particular matter or state of affairs. For more information about the kind of warranties investors may require please see the section below titled "investment agreement".

If a warranty is given and it later transpires that the statement was inaccurate at the time it was given, the person giving the warranty will be in breach of contract and may be liable to pay damages to the investors for any loss they have suffered as a result of the breach. Since the investors are likely to require both the investee company and you personally to give warranties any breach of the warranties may result in you incurring personal liability.

If the investors require anything more than very basic warranties it will be necessary to carry out a disclosure exercise. This will involve you setting out in writing (either in a schedule to the investment agreement or in a separate disclosure letter) details of any facts or circumstances which make the warranties inaccurate. The purpose of disclosure is to qualify the warranties in relation to the matters disclosed (i.e. you will not be liable for any breach of warranty which relates to a matter that you have properly disclosed).

It is very important that you make full disclosure. Warranty claims are rare because investors are understandably reluctant to bring claims against the founders of companies they have invested in. However, it is not unknown for investors to bring warranty claims where founders have wilfully made false disclosures or withheld material information.

Completion

At completion the investors pay their subscription monies (although often in practice advance payments have been made before completion to ensure compliance with SEIS / EIS rules) and the board of directors of your company allots the shares to the investors. In addition, there will usually be a number of other matters dealt with at completion. For example, if an investor is being appointed a director of the company his appointment will usually take effect from the date of completion.



If certain conditions must be met before the investment completes (e.g. advance assurance must be obtained from HMRC that the company qualifies under the SEIS / EIS schemes or various shareholder resolutions are required to reorganise the share capital and adopt new articles of association), there may be a period of time between the date the investment agreement is signed and the date the investment completes.

Registration and filing

Once the investment has completed the investee company's statutory books (in particular the register of members) must be updated, share certificates issued and all necessary filings made with the Registrar of Companies before the relevant filing deadlines (e.g. Form SH01 (return of allotment of shares) must be filed within 28 days).



LEGAL DOCUMENTS

Term sheet

The term sheet contains a summary of the key terms on which the investors have agreed to invest in your company. It is usually a very short document and is not legally binding (except in relation to a limited number of matters, including confidentiality, costs and governing law).

Confidentiality agreement

It is advisable to require the investors to enter into a confidentiality agreement with your company before due diligence commences. The law does provide your company with some protection against the unlawful use and disclosure of its confidential information by the investors. However, it will be easier for your company to enforce a well drafted confidentiality agreement against the investors if necessary.

The confidentiality agreement should require the investors to keep any non-public information about your company, its business, assets and liabilities that is disclosed during the course of the negotiations (in particular during due diligence) confidential. It should also state that investors can only use that information for the purpose of evaluating and negotiating the proposed investment.

Investment agreement

The investment agreement (known as the subscription and shareholders' agreement) is one of the main legal documents. It sets out the basic terms of the investment, including the amount to be invested and the shares to be issued to the investors. It also governs the ongoing relationship between the investors, your company, you and any other shareholders of the company. The investment agreement may contain some or all of the following terms:

Board representation – The investors may want the right to appoint a director to represent their interests on the board (commonly referred to as the “investor director”). In seed capital investments the investor director is usually one of the investors and is normally not paid a fee for his services (although he is usually reimbursed in respect of expenses and may be granted share options). Alternatively (or sometimes additionally), the investors may want the right to appoint an observer to attend (but not vote at) board meetings.

Veto rights – The investors may require that certain actions can only be carried out by the company with the consent of the investors. For example, issuing new shares/ granting options over shares, amending the company's articles of association, selling the company's assets, borrowing money and appointing or removing directors.

Information rights – The investors may require that the company provides them with certain financial information. For example, monthly management accounts, an operating budget and cash flow forecast and a copy of the annual accounts. The investors may also want the right to inspect the company's books and records.

Warranties – The investors may require that the company and its founders give certain warranties. For example, the investors may require warranties about the share capital of the company, litigation and disputes, intellectual property, employees, and taxation.

Articles of association

The investors are likely to require that the company adopts new articles of association at or before completion of the investments. The articles of association are a constitutional document that creates a



binding legal contract between the company and each of its shareholders in their capacity as shareholders. They set out the basic management and administrative structure of the company and regulate its internal affairs including, for example: (i) the issue and transfer of shares; (ii) board and shareholder meetings; (iii) powers and duties of directors; and (iv) dividends. The new articles of association may contain some or all of the following terms:

Board meetings – The investors may require more formality in relation to calling and holding of board meetings, including a minimum number of days’ notice of board meetings and a requirement that the “investor director” is present at all board meetings (if appointed).

Good leaver/bad leaver – The investors may require provisions in the articles forcing employee shareholders (including the founders) to offer their shares for sale in the event that they cease to be employed by the company. The price payable for the shares usually depends on whether the departing employee shareholder is a “good leaver” or a “bad leaver”. Good leavers are usually entitled to fair market value for their shares, whereas bad leavers are often only entitled to the nominal value of their shares (e.g. £1 per share). Good leaver/ bad leaver provisions are usually a heavily negotiated area of the articles.

Drag along/ tag along – It is important to include provisions in the company’s articles entitling the majority shareholders (i.e. generally speaking the founders at this stage) to force the minority shareholders to participate in a sale of the company. These provisions are known as “drag along rights”. The investors may require that the drag along rights are only exercisable with their consent. The investors may also require that provisions are included in the articles entitling the minority shareholders (in particular the investors) to participate in any sale of a controlling stake in the company. These provisions are known as “tag along rights”.

Disclosure Letter

The disclosure letter contains details of any facts or circumstances that are inconsistent with the warranties. The length of the disclosure letter depends on the number of warranties you are required to give the investors and company’s stage of development. There is usually very little to disclose in relation to very early stage companies, particularly where they have not yet started trading.

Employment contract

If you are an employee of your company (rather than a consultant) but have not already entered into an employment contract, the investors may make the investment conditional on you entering into an employment contract that is satisfactory to them. This means you effectively end up negotiating your employment contract with the investors. It is therefore a good idea to ensure that you have entered into an employment contract before you approach investors since as long as your employment contract is reasonable they are unlikely to require you to enter into a new one.

Register of members

All companies are required by law to keep a register of members setting out the names, addresses and shareholdings of the shareholders of the company. It is not uncommon for early stage companies to overlook the requirement to keep a register of members, but investors will want to know their shares have been registered in their names.



WHEN SHOULD YOU GET HELP?

You should seek professional advice before you sign a term sheet. Founders often wish to put off incurring professional fees for as long as possible. This is understandable but it can be a false economy. Although not legally binding term sheets create a moral commitment for the parties to observe the agreed terms. It can be difficult to renegotiate terms once the term sheet has been signed. It is best to ensure you fully understand what you are signing up to before you commit yourself (legally or otherwise).

That said, we're always happy to help at whichever stage you engage us... better late than never!

CONTACT US

We've just given you an overview of seed capital investments in this guide. If you would like more information please email or call us. We don't charge for an initial chat. Here are our details.

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