



THE LEGAL REQUIREMENTS FOR SETTING UP AN INVESTMENT AGREEMENT

October 2001

A Venture is a grand undertaking involving calculated risk taking and a great testing of resolve designed to achieve the extraordinary



Pytheas Limited
Mergers & Acquisitions
Email: investmentmanagement@pytheas.net
Website: <http://www.pytheas.net>



THE LEGAL REQUIREMENTS FOR SETTING UP AN INVESTMENT AGREEMENT

1. Background: Private Equity and Venture Capital - What's the difference?
2. Maximizing Value from the Due Diligence Process.
3. Identifying and Linking together Financial, Legal and Commercial Risks.
4. Different Forms of Investment Agreement.
5. Negotiating and Structuring the Investment Agreement - Legal Implications and Approach.



1 PRIVATE EQUITY AND VENTURE CAPITAL - WHAT'S THE DIFFERENCE?

- The terms “Private Equity” and “Venture Capital” are used loosely, sometimes interchangeably in Europe.
- The confusion is exacerbated by those Private Equity and Merchant Banker companies that use the name 'Venture Capitalist' at variance with their investment objectives and risk profile.
- The practical difference between the two relates to the risk profile of the investor and the stage of the business cycle in which they invest.
- **A Venture Capitalist or VC** has the primary motivation of making extraordinary profits. To do so the VC by necessity invests in start-ups and early stage companies often at high (yet calculated) risk of losing the initial investment.
- **A Private Equity Provider** has the primary motivation of retaining their initial capital. To do so the Private Equity Provider by necessity invests in established businesses with proven and sustainable cash-flow and profits and accordingly will receive a lower rate of return of their investment to reflect the lower risk.

Why an entrepreneur needs to know the difference

The distinction between private capital and venture capital is important, where an entrepreneur seeks capital. There is no point knocking on the wrong door. An entrepreneur's business plan should be targeted at those potential investors and industry players who are the most likely to be interested in investing in the company. There is little point in going to the cost and time of sending applications to persons who view themselves as private equity providers if you are in start up mode and vice versa.



2 MAXIMISING VALUE FROM THE DUE DILIGENCE PROCESS

2.1 What is due diligence?

Due diligence involves, assessing a business or an idea from a commercial, technical, financial and legal perspective with a view to putting a value on the business or potential business. This means that investors and their advisers run a fine toothcomb through the business, its assets and records and/or the business plan as appropriate.

2.2 What are investors looking for in legal due diligence?

- (a) **Risk Analysis:** At a basic level, legal due diligence involves risk analysis. For the investor, a range of risks may exist in relation to the business, such as:
- The accuracy of the past financial accounts of the business (if any) and its future projection.
 - Whether the business key personnel, suppliers and customers will remain.
 - Whether the business has good title to its assets.
 - Whether those assets are worth the value the company attributes to them and whether those assets will produce or do what the owners of the business say they will do (e.g. is more money required to complete the product or invention?)
 - Whether the business owns or has otherwise secured rights to any intellectual property which is key to the business or does it lie with individuals associated with the idea/business. With a view to a possible IPO or trade sale down the track, this issue is crucial to realizing the value of the business.
 - Whether there are any existing liabilities that may manifest themselves in the future to disrupt the operation or financial performance of the business.
 - Tax Risk – deductibility issues - When can depreciation be claimed? The timing of deductions affects cash flows?
 - The particular country's political risk. An overseas investor needs to be comfortable with the political risk.



(b) The Overall Investment Decision

Generally, the younger a business the less relevance or weight legal due diligence will have on an investment decision. However, where “holes” are uncovered in legal due diligence, the investment can be structured to gradually fill in such holes by only disbursing cash against agreed milestones. Of more relevance are commercial and technical factors such as:

- (i) **The Character of the Entrepreneur and Key Team Members:** Have you got the character to last the distance in what will be a consistently high pressure commercial undertaking? Is there a manager to clean up after the entrepreneur if necessary? Can the necessary key employees be recruited to replace gaps in the skills set including the CEO position? Do any of the teams have a shady past which could impact on the future ability to undertake an IPO?
- (ii) **Technical:** Does the technology stack up, is it possible, i.e. commercially executable? Can it be developed and brought to market quickly?

2.3 What Due Diligence Means to an Entrepreneur?

- (a) **Be Prepared:** You need to have all the answers ready for potential investors, particularly around your business valuation model. Any grey areas may be seized upon by an investor to talk the valuation of the business down and/or their equity share up or as a reason to walk away altogether (not that they need one!)
- (b) **Preparing for the Investors and Vendor Due Diligence:** Vendor due diligence is essentially the same process as purchaser or investor due diligence however, it is the job of your advisers to identify any problems and come up with solutions to them before potential investors view the opportunity or even receive a business plan. Vendor due diligence is crucial in rapid growth industries such as information technology, where a company’s business systems and records can quickly become outdated.

In our experience a well executed vendor due diligence will:

- (i) provide you with a better understanding of the true value of your business;
- (ii) result in more interested parties actually offering to invest and therefore creating greater competition;
- (iii) result in a greater financial commitment or valuation being put on the business or idea.



Being well prepared prior to allowing a prospective investor to view due diligence information will also result in the reduction of the due diligence time required by investors and free up management time, thus allowing management and staff to focus on ongoing business activities.

By ensuring thoroughness and integrity of due diligence information, a “mood of confidence” in the business or idea will result which will translate into more “serious” investors and a greater likelihood of receiving top dollar.

We have been involved in transactions where the vendor has achieved four times its original expectations due significantly to the due diligence preparation which greatly assisted in creating confidence and competitive tension.

Business Administration and Systems: It is critical that you can demonstrate that you have established good business systems and are in control in a management and business sense. You do not want to give the impression that you are in fire fighting mode, i.e. going from one issue to the next without some overall plan and strategy. Lawyers will not only assess what is there but *what is not there*, which is more to the point with a start up or early stage business. Due diligence is intended to show up the exceptions or material issues since a comparison is made with the business plan and the statement of what assets are owned or held by the company.

(c) Understand Where the Investor is Coming From and Plan Accordingly

To anticipate the Investors approach and areas of concern you need to understand:

- The underlying rationale for considering the investment.
- Identification of all parties involved.
- How the transaction is intended to be structured or assets are assumed to be required and what liabilities assumed to maximize the tax position of the investor(s).
- How the transaction is intended to be funded?
- Status and intended form of transaction documentation.
- How the investor intends to integrate or leverage the investee business with its own or its partners.
- Investor’s exit strategy.



(d) What Due Diligence Means to an Investor?

Again the message for the investor is one of planning to ensure an efficient and effective process.

- What is the objective of Due Diligence? Your objectives and expectations need to be clear at the outset and communicated to advisers;
- Which major areas need to be assessed? e.g. technical feasibility and Intellectual Property;
- What is the focus of due diligence i.e. materiality?

And for the bigger deals:

- Division of Responsibility - Who will be assigned to assess each area?
- Who will co-ordinate due diligence amongst the various advisers or investor?
- How will the reporting function be managed?



3 IDENTIFYING AND LINKING TOGETHER FINANCIAL, LEGAL AND COMMERCIAL RISKS

(a) What is the Impact of Due Diligence?

As a result of the Due Diligence exercise all the material financial, legal and commercial risks will (hopefully!) have been identified. This will likely have thrown up a spectrum of risks and problems from minor issues to major deal breakers. Such issues will be dealt with in the following methods:

- Eliminating the problems;
- Apportioning the risk;
- Structuring the transaction;
- Pricing the risks;
- Walking away.

(i) Eliminating the Problems

Due Diligence will produce a myriad of procedural irregularities that don't matter much in a commercial sense but need to be squared away legally i.e. documented e.g. Companies Act formalities. The entrepreneur also needs to ensure the entrepreneur and other players have vested all the intellectual property of the business in the company. Usually this can be dealt with simply.

(ii) Apportioning the Risk

Certain matters may not be able to be eliminated or due diligence will not reveal the whole picture and if the deal is to proceed the investor will want comfort around these areas e.g. past year potential tax liabilities, that the entrepreneur owns the intellectual property in the business, that the entrepreneur has disclosed all material details about the project to the investor; that the turnover is as stated. Such issues can be dealt with in the Investment Agreement by way of:

- Representations and warranties;
- Guarantees and Indemnities;
- Carve Outs.

These will be discussed later.



(iii) Structuring the Transaction

Identified risks can be avoided by choosing to buy put the business in a new company structure in which ownership is shared by investor and Investee rather than the investor buying shares in the Investee's existing company.

The nature of the Investee's business and its history and the nature of the Investor's business and its history may dictate the need for a specific company structure, primarily for tax reasons.

These and other factors relevant to structuring will be discussed under the *Different Forms of Investment Agreement*.

(iv) Pricing the Risk

Identified risks can simply be reflected in a lower valuation of the company and/or offer price for the equity share.

(v) Walking Away

If there is serious doubt about the business in any major area then the investor will be inclined to walk. In a start up early stage scenario this is more likely to be around business or commercial risk rather than legal. E.g. market research has indicated that there is serious competition to the venture not identified by the entrepreneur; the entrepreneur's motivation or his or her understanding of the business, the market and the competition is wanting.



4 DIFFERENT FORMS OF INVESTMENT AGREEMENT

(a) Structure

The *form* of Investment Agreement will follow the transaction structure and vehicle. Other factors beside those discussed in section 3(iii) relating to adoption of structure are:

- How best to get the product to market;
- How to incentivise management/the entrepreneur;
- Intellectual property protection;
- Entry and exit of investors;
- Sensitivity to risk;
- Extraction of money during ownership;
- Securities Act implications;
- Financing issues;
- Tax;
- Exit strategies.

(b) Vehicle

The above factors will influence the type of vehicle used, e.g.,

- Ordinary company
- Joint venture company
- Partnership
- Special partnership
- Trust

(c) Tax structuring

Tax structuring is an important issue for investors and whilst obtaining capital gains is the driving factor for most investments, tax issues play an important part.

Appropriate tax structuring can maximize returns (or minimise losses!). All of the above vehicle structures have tax features which are beyond the scope of this paper to address, but should be the subject of consideration at the outset.

Other Key Tax Issues

- Tax losses that are generated from the structure, as mentioned above, can sometimes be passed on to investors or alternatively carried forward. Planning for introduction of new capital needs to be undertaken in a way which ensures that existing tax losses are not lost e.g. continuity.



- The exit from the venture capital structure particularly if it is successful, may introduce tax considerations e.g. care needs to be taken around structures which involve the creation of new float vehicles with immediate on-sale to the market.

(d) Forms of Investment Agreement

As discussed above the *form* of Investment Agreement will follow the transaction structure and vehicle. The Agreement may in fact be in the form of a sale and purchase of shares or assets or a license or distribution agreement or combination of such agreements. For the purpose of this paper we assume that the investor and investee are in the position of the Investor taking a partial shareholding in the Investee Company.

Such Investment Agreement could involve the purchase by one or a combination of the following mechanisms:

- Equity investment with different share classes;
- Convertible notes;
- Options;
- Mezzanine debt;
- Subordinated debt.

In addition, voting and non-voting shares could be used to provide one party with greater control than the other.

The above mechanisms can generally be broken down into debt and equity instrument categories. Debt instruments generally attract interest and provide a priority over other shareholders on liquidation, whereas equity instruments don't. Hybrid instruments can do a combination of both.

For the purpose of this paper we will focus on the issues that are generally common to most equity, rather than debt, investments.



5 NEGOTIATING AND STRUCTURING THE INVESTMENT AGREEMENT - LEGAL IMPLICATIONS AND APPROACH

Here we will focus on some key concepts and how they should be approached:

- Control and Shareholding;
- How Much Equity to Give Away;
- Management and Shareholder Controls;
- Exit Strategies;
- Dilution Issues;
- Management Performance.

(a) Control and Shareholding?

Shareholding is simply the number of shares held in a company. Whilst there are exceptions, if you have 51% or more of the shares in a company you generally will have all the say or control in the running of the company. However, control can exist independently of a majority shareholding in a company. A minority shareholder can achieve control by contract with the other shareholders of the company i.e. that key decisions require unanimous approval of all shareholders/director appointees or by controlling assets delivered by the company, e.g. software.

Accordingly, if structured properly there will be little difference between the powers of a majority shareholder (usually the entrepreneur) and a minority shareholder (usually the investor) in the ability to dictate the major direction and decision making of the company. Generally, the difference in shareholding will only make a big difference on trade sale or IPO day! *

*Jim Clark made a paper profit of approximately \$US544 million on the float of Netscape; Marc Anderson (the brains behind Netscape) made a relatively small \$US58 million.

(b) How Much Equity to give Away?

The decision on how much equity to give away is one for the entrepreneur in his or her particular circumstances. Whilst you may have the best idea or business in the world, what it requires to realize its potential is capital and a full range of business expertise to implement the idea or business to make it a commercial winner. 100% of nothing is nothing. Depending very much on your objectives and the stage of business growth you are at, you may be faced with a decision of giving away a big chunk of your company to realize those expectations.



What is it usual to give up?

In return for a stake in the company the investor requires as much protection as possible to protect its capital, without being involved in day-to-day decision making. Invariably, and reasonably, a right of veto is required by an investor over key decision-making – i.e. those decisions which may have a serious impact on the finances or strategic direction of the business.

Pre sale protection focuses on due diligence investigation or obtaining historical information about the business, or in the case of an idea the market the business will operate in, and its competition. Generally, post sale protection for an investment involves putting in place a mixture of mechanisms to produce current information and to enforce an investor's rights. These are discussed below.

(c) Management & Shareholder Controls

(i) **Directorships:** Usually, the investor will require a position on the board of directors of the company, although some may simply require a right to appoint a director. A Board position not only allows a monitoring role to be carried out (including veto right over key decisions), but also allows the investor to add valuable experience and direction to the growing company. An active board position can however expose the director or his or her nominee to greater risk in the event of company failure.

(ii) **Information Flow and Key Decision Making:** Management and Shareholder controls are all about ensuring timely and regular information supply to the investor. This is essential because the investor will not have daily contact with the business. Management and shareholder controls focus on/involve:

- Management - A veto to right over key decision making;
- Financial - The methods by which and the amount a company spends;
- Employment - The remuneration, scope of tasks, restraint of trade and removal of the CEO/entrepreneur and other key employees;
- Shareholder – A veto to right over key decision-making.

(iii) **Key Decisions:** All directors/shareholders, as appropriate, need to approve key decisions such as:

- alteration of the Constitution;
- entering into of major transactions;
- operating outside the company's core businesses;
- major acquisitions or sales;
- key executive appointments;
- expenditure over a certain level;



- dividend payments;
- approval of annual business plans or variations from it.

The specific details of what constitutes key decisions requiring unanimous agreement needs to be worked through in each situation. It is a case of striking a balance between the legitimate commercial requirements of the investor and the practical requirements of running your business efficiently. An investor does not want to take away the entrepreneur's tools or creativity.

(iv) The Mechanisms: Management controls are affected through a variety of mechanisms – the Shareholders Agreement, Constitution, Investment Agreement and key Employment Contracts.

(i) Shareholders Agreement: A Shareholders Agreement is a contract between the shareholders of a company governing the exercise of their rights in relation to the other shareholders and the company. Usual provisions of a Shareholder's Agreement include:

- Key decisions will not be made without unanimous approval;
- Performance targets to be met by the company CEO and sanctions in the event they are not;
- Pre-emptive rights, requiring that where a shareholder wishes to sell its shares, the shares first be offered to other shareholders;
- The rights of shareholders to appoint directors;
- Deadlock provisions for dealing with disputes on key decisions;
- What happens where the company requires further capital;
- Rights to increase shareholding if the entrepreneur is in financial trouble.

(ii) Constitution: A constitution is the rules for governing a company. Its terms will generally mirror the shareholders agreement or incorporate it by reference. Often the investor has superior pre-emptive rights.



- (d) **Exit Strategies:** Ultimately, the investor will seek to exit the investment at a profit. The primary methods are IPO's and trade sales. The "eyes wide open" VC will have its exit strategy planned prior to entry into the investment: The entrepreneur also needs to have his or her exit strategy planned.
- (i) **Initial Public Offerings or IPOs:** IPOs or floats on a share-market are the preferred way for many companies, particularly technology companies, to realize their value. This option is vulnerable to market fluctuations as has recently been experienced both around Europe and worldwide. A float is a more intensive, costly and exhaustive process than a trade sale, and by its nature extremely public. The legal requirements of offering securities to the public, (Securities Act legislation and the Listing Rules of the relevant Stock Exchange), must also be complied with.
- (ii) **Trade Sales:** Trade sales are generally sales to buyers in the same or a related industry as the business to be sold. Buyers often pay a premium to enter the market or to stop their competitors gaining an advantage over them. A trade sale by competitive tender can lead to extraordinary premium. Such a premium may result from the buyer being an informed industry player (they should know what they are buying) and/or taking advantage of synergies between their businesses. This option provides greater flexibility than an IPO as no Listing Rules and "public" company restrictions apply.
- (e) **Dilution of Shareholding:** Where the Company needs a further cash injection the investor or a third party may be in the only position to provide it. Alternatively, you may need a strategic equity partner to grow the business. This gives the investor/third party an opportunity to increase his or her shareholding by paying cash to the company in return for the further issue of shares. This will essentially dilute the shareholding of existing shareholders in the company i.e. ultimately decrease your financial returns on exit.
- (f) **Management Performance:**
- (i) **Removal of Management:** The shareholders agreement/employment contract may provide for removal of the entrepreneur/CEO from management and a possible sale of the entrepreneurs shares to the investor where the performance is not up to scratch or at anytime and/or the milestones in the Business Plan are not achieved. Alternatively, the investor can require the entrepreneur to buy back it shares at a minimum



price level. The latter should be resisted as the investor should share the risk of the business not succeeding as should the entrepreneur – that's why it's called venture or risk capital. The conditions upon which the entrepreneur can be removed from the business should be clearly expressed. Such conditions should relate to company performance and not be arbitrary, i.e. at the whim of the investor.

(ii) Dilution of Shareholding or Increase of Investors Return: The Entrepreneur also needs to be wary of any draconian provisions that provide the investor with more of the pie or a huge return ahead of the entrepreneur usually in the event of the management failing to meet agreed performance targets.

(g) Other Issues:

(i) Unequal Allocation of the Premium: You must also ensure if possible that you can share in any premium where the investor might sell its shares to a third party. This can be achieved through a variety of mechanisms, e.g., pre-emptive rights and drag along.

(ii) Valuation: Whenever there is a question of the sale of the investors or entrepreneur's shares the valuation issue arises. The valuation method or methods should ideally be fair and reasonable i.e. not favouring or disadvantaging one shareholder over another, particularly in terms of the number of shares held. Mechanisms for establishing value can be specified in the Shareholders Agreement or Investment Agreement.

Disclaimer

The above notes have been compiled to assist you; however, actions taken as a result of this document are at the discretion of the reader and not Pytheas Limited.