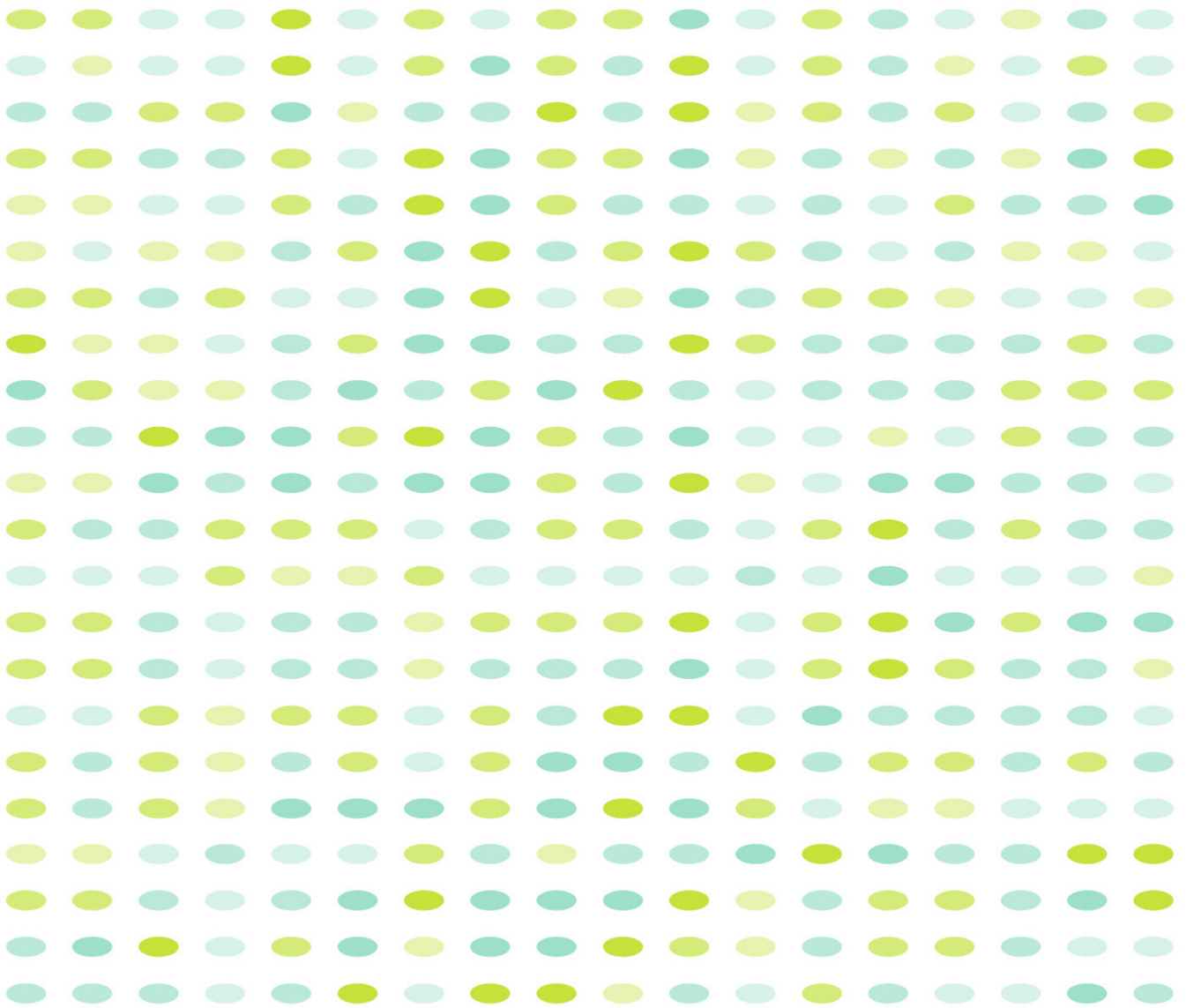


# The SWAIN guide to getting the best from your lawyer



In conjunction with:

# The SWAIN guide to getting the best from your lawyer

The South West Angel and Investor Network (SWAIN) connects private investors or “Business Angels” with companies looking for investments.

SWAIN specialises in helping small and medium sized companies to find equity finance, and assists private investors in the South West to search for investment opportunities in businesses with growth potential.

The following guide has been produced to help you understand the value that good commercial solicitors can bring to your deal. It is especially targeted at companies looking for investment, but the potential Business Angel will also find it of interest.

## Selecting your Legal Adviser

Key issues to consider when choosing your solicitor include:

Does your solicitor have significant corporate finance experience, especially in advising companies raising investment from Business Angels or in advising Business Angels themselves?

Have they the other specialist skills you may require, eg IP protection and licensing, ICT licensing or re-seller agreements?

Do they have experience of the issues faced by organisations within your sector?

If not, have you interviewed at least 2 lawyers with the appropriate commercial expertise?

While speaking to those lawyers have you obtained the names of two people for whom they acted in similar situations?

## When to involve your lawyer

It is important to involve your lawyer at as early a stage as possible when they can add most value. Too often clients only bring the lawyers in to finalise the legally binding documentation after the commercial deal has been agreed and cannot be altered. Or problems are thrown up in due diligence which cannot be resolved at all or within the timescale, but could have been dealt with if identified sooner.

The best time to involve your lawyer therefore is right at the outset when you are considering taking or making an investment.

## The good lawyer will:

- Advise on the process
- Explain the documentation required
- Advise on the structure of the deal
- Identify important issues that may need to be resolved.

## Pre-deal review

The legal pre-deal review is a different, more detailed process from the investor readiness review referred to in SWAIN's Guide to Investment Readiness.

The pre-deal review serves to identify and address legal issues which might cause problems later, eg:

- shareholding structure – the existence of minority shareholdings can sometimes cause difficulties if those shareholders might not support the deal;
- IP rights – is the company's intellectual property adequately protected and the important rights registered in the correct names?
- Employment issues – have key employees been signed up on proper service contracts containing adequate clauses dealing with ownership of intellectual property, confidentiality and restrictive covenants?
- Property issues – is there good title? Are there any serious environmental risks? Is there planning permission for the company's present and planned activities?

The corporate lawyer can identify those issues which are important to your business based on their experience of acting for similar businesses and dealing with Angel investors. They can advise you which issues need dealing with now and which can be left until later, if at all.

## Letter of Confidentiality/ Non-disclosure Agreement

Before you disclose any of your company's information to a potential investor, you should ensure that an adequate letter of confidentiality or non-disclosure agreement (NDA) is prepared and signed by all potential investors. It may be appropriate not only to place an express duty of confidentiality on them, but also to impose restrictive covenants on them competing with you or poaching ideas or employees. Your lawyer can advise you on what type of NDA is or is not suitable for you.

## Heads of Agreement

Heads of Agreement can take the form of a simple exchange of letters or a more extensive document. The main point of such a document is to focus the parties' minds on the key financial, commercial and legal issues. Advice should be taken from commercial lawyers and accountants on the Heads of Agreement to avoid unintentionally weakening your bargaining position.

Heads of Agreement are rarely intended to set out the main transaction in full or to be legally binding. However, there may be elements such as confidentiality, exclusivity of negotiations and costs which do have legal effect.

A degree of caution is worthwhile on the part of a target investee company as the Angel may regard the document as setting firm parameters to the deal.

## Due Diligence

This is the phrase used by accountants and lawyers to describe the investor's investigation and enquiry into the company seeking to raise equity.

This is generally divided into 3 main areas:

- Trading and commercial issues
- Finance, accounting and taxation issues
- Legal issues, including IPR, contracts, personnel and properties.

The process enables the investor to assess the legal, contractual and financial risk. For the company, early disclosure of relevant facts minimises the risk of "deal breaker" issues arising late in the day when substantial amounts of time and costs have been committed by all parties. If you have carried out a pre-deal review (see above) then this should, of course, have identified and dealt with any such "deal breaker" issues before contact has even been made with the investor.

The due diligence exercise may continue throughout the transaction process. Usually, however, the production and negotiation of the legal documents will not begin until an initial assessment has been made of the information and documents provided by the company.

Careful management of the passing of information is essential and one channel should be designated for the disclosure of all written information (usually the lawyers) so that all parties know what documents and information are being relied upon. The company may wish to limit the investor's rights to access written documentation. Confidentiality must be maintained to prevent loss of goodwill from existing employees and customers. Access to information may need to be given off premises or outside normal business hours.

## Subscription Agreement and related documents

The Subscription Agreement is the core legal document which will record the terms on which the Business Angel makes his or her investment into the company. The Angel's solicitors will usually prepare the first draft.

The Subscription Agreement will be a substantial document covering the following areas:

- Price for shares and percentage of equity granted
- Undertakings by the Company and its directors as to how the business will be conducted, what information will be provided to the investor, what matters will require investor consent
- Warranties (a series of statements made by the company and/or its directors and relied on by the investor about the condition and state of the company)
- Limits on the warrantors' liability for these warranties
- Restrictive covenants – preventing the warrantors from setting up in competition with the company
- The terms on which key directors and employees will be employed (set out in agreed form service agreements)
- What will happen to shareholdings in the event of a director or employee leaving (generally set out in agreed form Articles of Association which are to be adopted at completion).

If you can obtain a draft early on this will be a help. It is often true that terms Venture Capitalists perceive as entirely reasonable, businessmen find outrageously harsh.

## Disclosure Letter

The Subscription Agreement will, as mentioned, contain a comprehensive set of warranties on which the investor wishes to rely. To avoid uncertainty, warranties will be unambiguous. In reality, however, the warrantors will not always be able to give an unambiguous warranty and they may need to disclose information which qualifies particular warranties. This is done through a disclosure letter. For example, a warranty might require the warrantors to confirm that there is no actual or pending litigation, while the Disclosure Letter would list any current or threatened proceedings. It investigates full information, retains the assurance no other litigation exists and the warrantors reduce the risk of a claim from the investor.

Because warranties have become so comprehensive, disclosure is an important and time consuming obligation for the company and its directors. Much preparation can be done in advance if advice is sought early as would be the case with a pre-due diligence review.

## Tax Indemnity

If taxes have not been properly paid, then the asset base of the company or business or its retained profits will be reduced. If this has happened before completion of the investment this would have an effect on the terms of the investment. Sometimes, therefore, the investor will look to achieve a "£1 for £1" recompense.

## Memorandum and Articles of Association

Very often a Business Angel will require amendments to be made to the Articles of Association of the company (and sometimes the Memorandum of Association) before he or she makes their investment.

- The Memorandum of Association may need to be amended to extend the powers of the company.
- More generally the Articles of Association are amended to incorporate such matters as:
  - The investor's right to appoint a director to the Board
  - The different share rights (if the investor is not investing simply in ordinary shares)
  - Pre-emption rights on the transfer of existing shares or the issue of new shares
  - Provisions compelling a director or employee to sell their shares if they leave the company
  - "Drag-along" provisions enabling a majority of the shareholders to force the minority to sell with them, eg in the event of a trade sale
  - "Tag along" provisions where a minority can require a majority to compel a third party purchaser to offer them similar terms

## Time

Never under-estimate the management time involved in any process of raising equity capital. "Cleaning up" a company for investment and then negotiating the deal itself all take a vast amount of high level management time. This diverts attention away from the running of the existing business and consequently is likely to have an effect on short term profit. Do take this into account whether you are the company raising equity or the potential investor. However, a good team of advisers, lawyers, corporate accountants and other specialists as required can help to smooth the process and ensure that it does go through within a reasonable timescale.

Three months from first approaching SWAIN to achieving completion is probably the minimum timescale for a successful transaction.

## Cost

Good advisers do not come cheap.

However, most commercial law firms (and other advisers) are happy to speculate some time at the start, eg in initial meetings and discussion when you are considering raising equity capital.

All should give you a clear idea of the likely cost at the outset.

## Conclusion

If you are thinking of making an equity investment in a private company or you are a company looking to raise such investment, taking early advice from a good firm of commercial solicitors can avoid legal pitfalls and can save you time and money.

Details of such firms who are associate members of SWAIN can be found at

[www.swain.org.uk](http://www.swain.org.uk)

Or if you would like to discuss any of the issues raised in this guidance note, please contact any of the following at Foot Anstey, Solicitors which has prepared this guide. Foot Anstey, Solicitors is a regional law firm based in the South West with offices in Exeter, Plymouth and Taunton.

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