“Business Angels are the most significant source of investment in early stage and high-risk companies, bringing both finance and business building skills”

Anthony Clarke, BBAA Chairman
Business Angel Investing is the most significant source of equity for early stage businesses in the UK with between £800m and £1bn being invested in SMEs on an annual basis.

Recent research carried out by NESTA in collaboration with the BBAA has shown that whilst Angel Investing carries risk, investments in SMEs can bring attractive returns, demonstrating the importance of Angel Investing as a key asset class. This has important implications for high net worth and sophisticated individuals who could consider becoming Angel Investors as part of their investment portfolio.

In the current economic climate, there has been a significant increase in demand from entrepreneurs seeking access to alternative sources of investment. It is therefore vital that we attract more Business Angels to nurture the innovating businesses of tomorrow and to assist in maintaining the future competitiveness of the UK’s economy.

The recent downturn has increased the numbers of persons with longstanding industry and management experience who could bring their expertise and finance capability to make successful investments in these high growth potential entrepreneurs. The BBAA has gained the support of The Department of Business Innovation & Skills to run a major investment awareness campaign throughout 2009 with the aim of increasing the overall pool of Angel Investors across the UK.

The campaign has been running at both national and regional levels, with a programme of awareness events and workshops to build the capacity of potential new Angels. Notably, the campaign is designed to support actions being taken by Business Angel networks and to work directly with the Regional Development Agencies, key business organisations, finance and wealth managers and all professional agencies and intermediaries who are advising high net worth or sophisticated individuals who may be attracted to Angel Investing.

The BBAA is pleased to be able to put forward this new Guide to the Legal, Tax and Regulatory Issues concerning Angel Investing as part of our Awareness Campaign. I hope that both potential and experienced Angel Investors find this Guide useful. I should like to thank the Legal & Technical Committee for their invaluable contribution as well as the BBAA secretariat team for putting the document together.

Anthony Clarke, BBAA Chairman October 2009

Disclaimer
Please be aware that all the information contained in this handbook is a guide and should not be considered to be legal or technical advice. Accordingly the BBAA or any individual contributor or their firms cannot be liable to companies relying upon the content. Indeed, specific professional advise should be sought in the context of any particular investment.
Introduction from Jon Sutcliffe, BBAA Legal & Technical Committee Chairman

Angel Investing to those not familiar with the process may seem daunting and complex. This Guide of FAQs aims to address the many queries that may arise by those considering Angel Investing for the first time. The publication of this Guide is timely and coincides with the national BBAA Angel Awareness Campaign. It is hoped that by reading this Guide, those considering investing as an Angel will quickly become more effective and knowledgeable about the legal and regulatory processes surrounding the asset class.

This publication addresses a variety of topics including legal, tax and regulatory issues that may be of concern to a potential new Angel Investor and will be updated as new questions are raised. An electronic version will be available on the BBAA website – www.bbaa.org.uk.

I would like to thank all Committee members for their hard work over the inaugural 12 months of this Committee’s existence and for their invaluable contributions to this Guide. The Committee members are listed below, together with a short synopsis of their individual expertise. If you would like further information please do contact them directly or the BBAA at info@bbaa.org.uk.
BBAA Legal & Technical Committee Members

Jon Sutcliffe, Partner, Kingston Smith LLP, jsutcliffe@kingstonsmith.co.uk / www.kingstonsmith.co.uk
Jon is a general practice partner at Kingston Smith LLP, and advises a range of sole traders, partnerships and companies ranging from start-ups to mature businesses on many aspects of their financial affairs. He heads up the firm’s specialist offering to technology businesses, and also advises clients in the healthcare sector, security and investment businesses. Services provided include dealing with audit, accounts, fundraising and the interaction between businesses and personal taxation issues. Jon regularly writes in the business section of the Sunday Times, answering questions in its Business Doctor column.

Steve Barnett, Partner, Fox Williams LLP, sbarnett@foxwilliams.com / www.foxwilliams.com
Steve Barnett is a partner in Fox Williams’ Corporate group and advises on a broad range of corporate transactions. He is also an active member of the firm's ebusiness group, and advises a number of clients operating in this sector. He specialises in corporate finance work, including mergers and acquisitions, private equity, and joint ventures, with many transactions having a technology focus. Steve is also a member of the International Association of Young Lawyers (AIJA).

Ben Blackett-Ord, Chief Executive, Bovill, bblackett-ord@bovill.com / www.bovill.com
Ben is an experienced financial services regulatory practitioner having served as a regulator, compliance officer and consultant for over twenty years. He established Bovill in 1999. Ben is a qualified barrister and is regularly invited to speak on regulatory issues at conferences throughout the UK. He is highly respected for his thorough and client focused approach. He is a director of the EIS Association.

Robert Bough, Associate, Eversheds, robertbough@eversheds.com / www.eversheds.com
Robert is a senior lawyer in Eversheds’ corporate practice. Robert’s practice focuses on M&A and corporate transactions, particularly private equity financings and venture capital investments. He advises a range of UK companies at differing stages of growth on fund raising opportunities, whether from venture capital houses or private investors.

Sandy Finlayson, Senior Partner, MBM Commercial LLP
sandy.finlayson@mbmcommercial.co.uk / www.mbmcommercial.co.uk
Sandy is a partner in the Corporate Group specialising in corporate finance for high growth young companies. He brought together the founders of ArchAngel Informal Investment Ltd in 1992 and found a number of their early deals which produced very successful outcomes. Since then he has been involved in numerous innovative ventures to finance high growth start-ups, including one of the first venture capital trusts, the first two ERDF funds in Scotland, a number of business Angel syndicates and two Enterprise Capital Funds, including Seraphim Capital, the UK’s first and only business Angel led Enterprise Capital Fund.

Jon Gill, Solicitor, Eversheds, jongill@eversheds.com / www.eversheds.com
Jon is a solicitor in the international corporate group, specialising in mergers and acquisitions and private equity, with a particular interest in venture capital and Business Angel investments. Prior to joining Eversheds, Jon obtained an MSc in Entrepreneurship with Distinction from the University of Bristol. He is the author of “Business Law for the Entrepreneur” and also holds IBA Practice Diplomas in International Business Organisations, International Mergers and Acquisitions and International Joint Ventures, together with the ICAEW Certificate in Corporate Finance.
Justin Hill, Director of IP Prosecution, McDermott, Will & Emery LLP, juhill@mwe.com/ www.mwe.com

Justin Hill, Ph.D. is Head of IP Prosecution at McDermott Will & Emery UK LLP. He is a member of the Intellectual Property, Media & Technology Department, where his practice focuses on broad range of IP matters, covering the procurement, exploitation and enforcement of IP rights including patents, designs, trade marks and trade secrets. Justin is a European patent attorney, a chartered patent attorney and a chartered physicist. He is also a member of the Institute of Professional Representatives Before the European Patent Office, the Chartered Institute of Patent Agents, The Institute of Physics and serves on the Special Advisory Committee for Computer Implemented Inventions. Justin is recommended in the Legal 500 2009 as being "extremely impressive", "one of the pre-eminent patent prosecution attorneys in the EU, with a phenomenal grasp of even the most complex and obscure patent issues."

Russell Warren, Senior Tax Associate, Travers Smith, russell.warren@traverssmith.com/ www.traverssmith.co.uk

Russell Warren trained at Travers Smith and is a senior associate in their Tax Department. He undertakes a wide range of transactional and advisory work in the venture and private equity markets. His recent work has included:
- Advising investors on the availability of Enterprise Investment Scheme relief;
- Designing and implementing various employee incentive share plans with particular experience in synthetic exit incentives;
- Advising management teams on their buy-outs of Jimmy Choo, Bounty and Dorset Cereals and private Equity houses on their acquisitions of Pret a Manger, Pets at Home and Fat Face;
- Advising Force India on its acquisition of the Spyker F1 racing team;
- Advising management of NDS plc on the partial take private by Permira.

Russell is a member of the EIS Association.
Are you considering Business Angel Investing?

Business Angels invest both their expertise and money into small businesses to help them grow and achieve success in return for shares in the company.

Business Angel Investing is not new and has been established for many years. There are an estimated 18,000 investors across the whole of the UK and around £800m is invested by Angels on an annual basis.

Angel Investment is generally focused on early stage companies with high growth potential and a scalable business model, with a strong chance of good returns. Generally Angels would seek 10x return on the investment over a period of around 3-5 years.

Business Angels bring not only investment to the company but also provide business and finance experience, contacts and access to potential customers.

There are various legal, tax and regulatory issues surrounding Business Angel Investing. This Guide will give you a detailed insight into these issues associated with Business Angel Investing.

It is often thought that you have to be very wealthy to be an Angel Investor, but in fact many individuals invest from around £10,000 in any one company, however some Angels invest much more. Most investors take a portfolio approach and invest in more than one company to give a spread of opportunities to diversify their risks. However, your money is tied up for several years so it must be money outside your normal finance needs.

Generally Angels invest in syndicates and this way they can group their smaller size investments to create the level of finance that a business needs. One investor will generally act as Lead Angel on behalf of the syndicate. It is always important to carry out due diligence and draw up legal agreements to protect your investment relationship with the business.

“Angel Investing is vital for the growth of small businesses during this challenging economic climate – we need more Angels to come forward ” Anthony Clarke, BBAA Chairman

For more information about Business Angel Investing, and to access local angel networks and events in your region, please contact the BBAA:
Tel: 0203 7089 2305; email: info@bbaa.org.uk; or visit www.bbaa.org.uk/awareness.
Section A – Initial Considerations about Angel Investing

1. Am I eligible to become a Business Angel?

To become an Angel Investor you must either be a certified high net worth individual or a self-certified sophisticated Angel Investor.

To become a certified high net worth individual you must ensure one of the following applies:

(i) I had, during the financial year immediately preceding the certification date, an annual income to the value of £100,000 or more;

(ii) I held, throughout the financial year immediately preceding the certification date net assets to the value of £250,000 or more. Net assets for these purposes do not include:

• The property which is my primary residence or any loan secured on that residence;

• Any rights under a qualifying contract of insurance within the meaning of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001;

• Any benefits (in the form of pensions or otherwise) which are payable on the termination of service or on my death or retirement and to which I am (or my dependants are), or may be, entitled.

To become a self-certified sophisticated Angel Investor you must ensure one of the following applies:

(i) I am a member of a network or syndicate of Business Angels and have been so for at least the last six months prior to the certification date;

(ii) I have made more than one investment in an unlisted company in the two years prior to the certification date;

(iii) I am working, or have worked in the two years prior to this date, in a professional capacity in the private equity sector, or in the provision of finance for small and medium enterprises;

(iv) I am currently, or have been in the two years prior to the certification date, a director of a company with an annual turnover of at least £1 million.

2. Your tax relief opportunities

2.1 The Enterprise Investment Scheme

The Enterprise Investment Scheme (EIS) is designed to encourage investments in small unquoted companies carrying on a qualifying trade in the United Kingdom through providing Angels with tax relief. Investment in companies that are not listed on a stock exchange often carries a high risk. The tax relief is intended to offer some compensation for that risk. The EIS offers both income tax and capital gains tax relief to investors who subscribe for shares in qualifying companies. For more information please visit www.eisa.org.uk (Enterprise Investment Scheme Association).

(a) What relief is available through EIS scheme?

Where EIS relief is available, the Business Angel will qualify for the following tax breaks:

• 20% income tax relief on up to £500,000 of investment per year;

• Exemption from capital gains tax on disposal of EIS shares after 3 years;

• Allowing losses on the sale of the EIS shares to be set off against either income or capital amounts;

• Unlimited capital gains tax deferral on amount reinvested in EIS shares.

EIS is designed to encourage investment by Business Angels in smaller companies. In particular, Business Angels who are considering investing need to seek confirmation that their investment qualifies for relief before committing to invest. This can be done by ensuring that the investee company qualifies for EIS status.
(b) Which investments will qualify for EIS status?
Not all investments and not all types of investors will qualify for EIS. There are complex rules governing when an investor may qualify, these include requirements in relation to “connections” between the investor and the company and the receipt of value by the investor from the company.

(c) Which companies will qualify for EIS status?
Companies will only qualify if they meet the following conditions:
- Have gross assets of not more than £7m pre-investment;
- Have fewer than 50 employees;
- Are “independent”;
- Carry on a qualifying trade as defined by the EIS.

There is a formal process for the company to complete to be EIS eligible. Whilst these rules are deceptively simple, there are many traps for the unwary and many companies inadvertently fail to meet the qualifying criteria, as highlighted in the Court of Appeal’s recent judgment in the case of Blackburn and another v Revenue and Customs Commissioner [2008].

(d) How is EIS tax relief obtained?
There is a formal application process which must be completed for the relief to be made available. If you are considering applying for EIS relief, please see “where can I find out more” below for the contact details of someone who will be able to assist.

(e) Can the relief be forfeited?
It is a harsh facet of the EIS regime that the relief can be lost or clawed back in a number of circumstances within three years of acquisition of the shares. Both EIS and VCT relief can be lost after the initial investment unless the company continues to satisfy the relevant conditions.

(f) Under what circumstances would EIS relief be forfeited?
Some examples of this include:
- The sale of EIS shares;
- The investor increasing their proportionate holding of shares or loan capital such that they become connected with the company;
- The investor receiving value from the company e.g. where loans are made or assets are sold at less than full value;
- The company ceasing to trade wholly or mainly in the UK;
- The nature of the share rights changing so that they cease to be eligible shares.

The loss of qualifying status can have very serious repercussions for investors. Monitoring the day to day running of the company to ensure that relief is not inadvertently lost is crucial.

Each of these requirements have specific rules attached to them. Further details on some of the more complex of these requirements are set out below.

(g) How does the investor become “connected” to the company?
An investor can be connected to a company financially or by way of employment. An investor will become connected to a company financially if they:
• Acquire more than 30% of the share capital (or share and loan capital taken together) or voting rights;
• Are entitled to more than 30% of the assets on a winding up;
• Acquire more than 30% of the voting power.

An investor will become connected to a company by employment if they become either a partner, a director or an employee, of the EIS company or any of its subsidiaries.

Directors are not automatically connected for these purposes but their relationship with the EIS company must be carefully regulated to ensure EIS relief is not lost or reduced.

(h) When is an investor deemed to “receive value” from a company?
An investor will receive value from an EIS company if, amongst other things, the EIS company:
• Advances a loan or provides a benefit to the investor;
• Sells an asset to the investor at less than market value;
• Acquires an asset from the investor for more than market value;
• Repays or repurchases its own share capital from any shareholder;
• Acquires shares in, or assets of, a company which the investor controls.

(i) What is a qualifying holding?
The rules governing whether a particular investment is a qualifying holding are complex and go beyond the scope of these FAQs. However it depends broadly upon:
• The form of the investment;
• The type of company invested in;
• The way in which the money raised is used.

(j) What are eligible shares?
Broadly, eligible shares are:
• Comprised in the company’s ordinary share capital;
• Carry no present or future preferential right to dividends or to the company’s assets in a winding up;
• Carry no present or future right to be redeemed.

(k) When will shares cease to be “eligible shares”?
The shares issued to the investor must continue to be eligible shares which means they:
• Cannot carry any present or future preferential rights to dividends, to the EIS company’s assets on a winding up or a right to be redeemed;
• Must be subscribed for and issued for bona fide commercial purposes and not as part of a tax avoidance scheme; or
• Must be issued to raise money for the purpose of a qualifying business activity.

Money raised by any other shares comprised in the same issue must also be used for that purpose. Time limits apply within which the money must be used.

2.2 IHT & Self-Invested Personal Pension (SIPP)
(a) Can I use funds from my SIPP alongside my non-pension Business Angel Investments?
Yes you can. However, be aware that by no means do all SIPP providers allow investment in unquoted shares. Additionally if the company in which you are investing owns residential property or tangible moveable assets
valued at more than £6,000 then a tax charge of up to 70% may be applied, unless a complicated set of conditions regarding business activity and share ownership are met by the company and its directors.

(b) Is there a limit to how much my SIPP can invest in this manner?
Subject to the legislative constraints mentioned above, no.

(c) Can I get EIS relief if I personally invest alongside my SIPP?
Yes. Your pension is regarded as a separate legal entity and has no impact on your own qualification for EIS relief.

(d) If my SIPP provider does not allow equity investment, can I move my SIPP to one that does?
Yes you can. There will invariably be costs associated with such a transfer. If your current plan is with a low cost no frills provider, you will usually find that the ongoing running costs will increase.

(e) How can I find out about SIPP providers and move my SIPP?
Most SIPP providers have a web presence that details their pension offering. Alternatively an Independent Financial Adviser should be able to research this on your behalf to ensure that the arrangement is suitable for your requirements.

(f) What are the drawbacks of using a SIPP for equity investment?
As noted above, the legislative controls over ownership of unlisted shares in a SIPP are much tighter than they are for direct ownership. In addition there will be charges, typically around 1% of the original purchase and then 0.75% of the shares’ value each year in addition to any other SIPP charges.

(g) If I have an EIS investment, can I transfer it to my SIPP?
You can, but this would be regarded as a disposal for capital gains tax and income tax purposes. You would need to balance this against the tax advantages provided by the pension fund.

(h) Will my investment be liable to IHT?
If the shares meet the criteria that qualifies them for Business Property Relief (e.g. the business is a trading company and not an investment company), then after two years your investment would be free from IHT.

(i) What are the tax implications if I transfer shareholdings to my children?
There are no immediate inheritance tax implications if you transfer your shareholdings to your children. If the shareholdings qualify for BPR and you have held them for two years or more then they will be free of inheritance tax when you die. If they do not qualify or you have not held them for two years then they will be regarded as a Potentially Exempt Transfer (PET) and you will need to survive the gift for seven years in order to avoid an inheritance tax charge.

2.3 Business Property Relief

(a) When does business property relief (‘BPR’) apply?
There is no requirement that business property be located in the UK for BPR to apply, so the relief is therefore applicable to both foreign business property as well as business property located in the United Kingdom.

Depending on the nature of property, the relief operates by reducing the value of the business property transferred by either 100% or 50% and as a consequence there will be a reduction in IHT payable. BPR is specific to the property transferred and is applied before all other exemptions and reliefs.
BPR applies to what is referred to in the Act as ‘relevant business property’. A business property attracting 100% relief would constitute:

- Property consisting of a business e.g. the business of a sole trader;
- Property consisting of an interest in a business e.g. a partnership share;
- Securities of an unquoted company which, either by themselves or together with other such securities owned by the transferor, gave the transferor control of the company;
- Any unquoted shares (but not securities) in a company.

A relevant business property attracting 50% relief would constitute:

- Listed shares or securities which gave the transferor control of the company at the date of the transfer, whether or not the whole of the controlling holding is transferred;
- Any land, building plant or machinery which, immediately before the transfer, was used by a partnership in which the transferor was a partner or by a company of which he had control. This is only relevant business property if it was used in the business for two years before the relevant transfer.
- Any land, building, plant or machinery which was settled property, in which the transferor had an interest in possession, and immediately before the transfer was used by a partnership in which the transferor had a share or a business which he controlled.

In determining whether the transferor has 'control' of a company, the transferor must control the majority of votes (i.e. more than 50% of the votes) for all aspects of the company.

(b) What investments will not qualify for BPR?
Broadly speaking the investment needs to be in a company that is carrying out a profession or vocation. Investment companies do not qualify. Relief is not available with respect to all commercial activities, where the business consists wholly or mainly of dealing in securities, stocks and shares, land or buildings, or making or holding investments.

(c) What are the ownership requirements of the business for BPR to apply?
To qualify for BPR, the transferor must have owned the relevant business property for at least two years immediately before the transfer. If however the relevant business property has replaced other relevant business property, the ownership requirement is treated as being satisfied, if the periods of ownership together comprised a total of two years within the five years immediately before the transfer.

Where an individual acquires business property on the death of their spouse or civil partner, the period of ownership is added to that of the other spouse or civil partner. The spouses’ or civil partners’ periods of ownership will not be added together where the transfer of property was made as a lifetime transfer.

(d) What can cause an Angel Investment to cease to qualify for BPR?
Stopping trading would jeopardise BPR. A more common trap to fall in to is holding too much cash in the company.
Section B – Regulatory Considerations

1. Are there any regulatory issues involved in Business Angel Investment?
The short answer to this question is yes, however this is dependent on who you are and what you are doing in relation to Business Angel Investment. To determine whether there are any regulatory issues involved will depend on whether or not you are conducting any ‘regulated activities’ by ‘way of business’. Both terms are defined in the Regulated Activities Order (the ‘RAO’). This is discussed in more detail below.

1.1 Individual Business Angels
On the whole, individual Business Angels making Business Angel Investments are unlikely to be caught by any regulatory issues. For example, an investor who negotiates directly with an investee company and makes his own investment decision without any external input is not affected by the RAO, and does not need to be authorised by the FSA.

As an individual Angel investor under the Financial Promotions Order (FPO) you are entitled to receive business plans and make investments through your own decision, provided that you can prove that you are certified as either a High Net worth Individual or a Sophisticated Investor. To comply with this you need to sign a certificate which declares that you comply with at least one of the following two categories:

Either:
- A Certified high net worth individual: you confirm that you have a net income in excess of £100K or net assets in excess of £250K beyond your pension fund assets and your private residence;

Or:
- A Certified sophisticated investor: you confirm that you have been one of the following:
  - A director of a company turning over at least £1 million within the last two years;
  - Have made more than one investment in an unlisted company in the last two years;
  - A member of a network or syndicate of business angels for at least six months
  - Have worked in the past two years in a professional capacity in the private equity sector or in the provision of finance for small and medium enterprises;

1.2 Business Angel Networks
It is generally advisable for individuals to join a Business Angel Network, which often run on a not for profit basis and often with a geographical focus, where you will not get involved in any regulatory issues. You will make your own investment decisions as an individual or a group of investors; however you must ensure that you have certified yourself as above. Business Angel networks usually have a ‘gatekeeper’ that selects the initial deals and presents them to the investor network members.

Many Business Angel networks in the UK run on a non-regulated basis whereby the gatekeeper, acting as a facilitator, reads the business plans and meets the entrepreneurs, and subsequently decides which propositions should be presented to the investors, but does not get engaged in the deal process or give investment advice. The investors can invest alone within the network or form a syndicate of high net worth/sophisticated individuals taking their own individual decision. This should be underpinned by wording in the Shareholders Agreement, signed at completion by the investors (see Section C below).

1.3 Setting up a Business Angel syndicate
You may decide that you would like to form a new Business Angel syndicate, a constituted group of investors usually represented by a gatekeeper. Syndicates typically invest on a fairly structured basis using standard investment documentation. Where an investor invests through a syndicate or network, or there is a gatekeeper or lead investor involved, the different aspects of the RAO need to be carefully considered.
2. Regulated Activities Order (Business Angel Syndicate)

The general rule is that only an "authorised person" may carry on regulated activities, which include arranging deals and managing investments, in relation to "specified investments," which include shares and options in private companies. This is a complex area and advice should be sought in all cases.

For example, when a formal Business Angel syndicate fundraises by targeting investors, and communicates a business plan or information memorandum relating to a proposed investment in a private company, this would be considered a financial promotion under the FPO.

The following points may have a bearing on whether or not regulated activities are being conducted:

• Whether all members of the syndicate make their own investment decisions, or whether the lead angel or gatekeeper has a measure of investment discretion;
• Whether the syndicate should be structured as a not for profit entity;
• Whether the gatekeeper is responsible for carrying out due diligence (which is not a regulated activity) and communicating with investors who have signed an FPO Certificate (see below);
• The extent to which the lead angel(s) then arrange the deal or communicate the arrangements;
• Having made the investment decision, the extent to which the investor may then grant the gatekeeper a power of attorney to negotiate and finalise the investment on his behalf and conclude the legal agreements;
• The extent to which the gatekeeper must not give any ‘investment advice’ within the meaning of the RAO.

As the provisions of the RAO are complex, it is important to take professional advice before establishing a syndicate to determine whether it can take advantage of the various exemptions specified above, or whether it is necessary to obtain FSA authorisation.


You will be asked to provide proof of identity to comply with the requirements of MLR for all investments above a de minimis threshold of £15,000 for a single transaction.

4. Markets in Financial Instruments Directive (MiFID)

MiFID is unlikely to apply to the activities of a Business Angel syndicate, provided it does not hold cash on behalf of its members. All subscription monies should therefore be paid direct to the investee company or to the professional advisors who are responsible for completing the investment.

5. Prospectus Regulations

The Prospectus Regulations will apply if a financial promotion document (a Business Plan or Investment Memorandum) is circulated to more than 100 people unless the minimum subscription is in excess of £50,000. For this reason, circulation of such documents is usually tightly controlled.

6. Investor protection

Investors who undertake this type of investment activity are unlikely to enjoy any protection under the Financial Services Compensation Scheme (FSCS). However, many investors choose to invest in a group, partly to spread the investment risk and partly to obtain the benefit of the experience of other investors, who may have particular expertise of relevance to the investment in question. It is vital to ensure that legal advice is gained and appropriate legal documents are therefore drawn up which set out the relationships between the individual investors and with the company.

For more information please see Section C, Legal Documents Required
1. Initial considerations – structuring the deal

(a) How long should I allow to conclude a transaction once terms have been agreed in principle?
As a rough guide, a period of around eight weeks from reaching agreement in principle should be sufficient to conclude an investment, although the actual length of time required will vary from transaction to transaction – the factors listed below can all be relevant:

- **The amount being raised** – a smaller investment may result in shorter legal documents and therefore less time being devoted to that aspect of the transaction;
- **The amount of due diligence which the investor wishes to undertake** – again, with a small investment, an investor may spend less time on due diligence. Generally, the longer the trading history of the target company, the more due diligence will be required;
- **The number of investors participating in the funding round** – the process can be easier to manage with a smaller number of investors.

It is also important to remember that lengthy negotiations may have taken place in order to reach an agreement in principle, so the entire process from first contact through to receipt of the investment can easily take 3 – 4 months to conclude.

(b) I have been told that it can be helpful to produce ‘heads of terms’ – what are they?
The heads of terms (also known as a term sheet, letter of intent or memorandum of understanding) is a document which sets out the main terms of the proposed investment and any pre-conditions to the making of the investment (such as satisfactory due diligence, confirmation of the availability of EIS relief or Keyman insurance for key employees). Except for confidentiality restrictions and exclusivity periods, heads of terms are usually not legally binding. Heads of terms help to provide clarity for all parties (and their respective advisers) as to the main terms of the deal at an early stage of the process, and as such they can be very beneficial. However, in the context of a Business Angel Investment it is important to keep the heads of terms as simple as possible in order to avoid being drawn into protracted negotiations on that document. A standard form term sheet is available on the BBAA’s website, under precedent legal documentation.

(c) What due diligence is commonly undertaken by an investor?
From an investor’s perspective due diligence is particularly important, as it provides an opportunity to investigate the target company before committing to an investment. The actual level of due diligence undertaken will vary depending upon a number of factors such as the size of the investment, the nature of the business and its prior trading history. The due diligence exercise will commonly cover some or all of the following:

- **Legal** – for example, checking that the company has been properly incorporated; reviewing any major commercial contracts which may be in place; checking whether employees have appropriate employment contracts in place; and ascertaining ownership of intellectual property (particularly important for companies operating in the technology sector).
- **Financial** – ensuring that there are no “black holes” in the accounts and assessing the company’s future projections and forecasts.
- **Commercial** – understanding the company’s target market and possibly speaking with key customers.

Perhaps equally important from an investor’s perspective is due diligence on the management team. Ultimately, an investor will be backing the founders/management to deliver returns on the investment made and from the commencement of discussions an investor should be focusing on whether the right people are in place to achieve this. There are a number of potential warning signs for investors, including founders who have committed little of
their own money to the business, management teams lacking key individuals (and with little or no awareness of the deficiency) and businesses which appear to be more of a lifestyle choice.

In the rush to launch a business, and when money is tight, many businesses are tempted to spend less time addressing legal issues than they ideally should. In the medium term, this can prove to be a false economy since any shortcomings are likely to be flushed out by the legal due diligence process undertaken by Angel Investors. Where problems are revealed, then at the very least this is likely to impact upon the timing of the investment whilst they are thoroughly investigated and potential solutions are explored. In a worst-case scenario, problems revealed during due diligence can impact upon the willingness of an investor to proceed with the investment.

The founders of a company are likely to be asked to stand behind the information provided in response to the due diligence exercise, through warranties given to the investor in the investment and shareholders’ agreement (which is dealt with in more detail elsewhere in these FAQs).

(d) Should an investor be required to sign a non-disclosure agreement (NDA) before the entrepreneur discloses any confidential information in connection with the investment opportunity?

From the target company’s perspective an NDA in its favour can be helpful. In practice many Business Angels refuse to sign them (at least in the early stages of a transaction), largely due to the number of business plans which they receive. (Normally the NDA is required after the agreement has been reached in principle but before detailed due diligence has started.)

2. Legal documents required

(a) What legal documents are likely to be required in order to finalise the investment?

In addition to heads of terms and possibly an NDA, you will almost certainly encounter the following documents:

- **Investment and shareholders’ agreement** – this document sets out the terms of the investment and regulates the relationship of the shareholders once the investment has been completed. It will address the specific rights of the Angel Investor(s), such as rights to appoint directors, to receive information on the business and to veto certain actions of the company. A model form investment and shareholders’ agreement appears on the BBAA’s website and further information on this document is outlined in more detail elsewhere in these FAQs.

- **Articles of association** – a company’s articles of association set out its internal regulations and deal with its management and administration. They deal with matters such as transfers of shares, dividends and voting rights, and complement the investment and shareholders’ agreement. Again, precedent articles of association appear on the BBAA’s website and further information on this document is set out in other FAQs.

- **Disclosure letter** – the disclosure letter sets out disclosures against the warranties contained in the investment and shareholders’ agreement. It is a very important document and is dealt with in the following section.

These documents may also be required:

- **Assignments of intellectual property** – due diligence enquiries often reveal that key items of intellectual property are owned by one of the founder shareholders rather than the company. Most Angel Investors will insist, as a pre-condition to completion that the intellectual property in question is assigned to the company.

- **Service agreements** – these may be required if the senior management team either do not have employment contracts in place, or if those which are in place are no longer considered appropriate.
• **Share option agreements** – share options may be granted if it is important to incentivise other senior members of the management team who do not currently hold shares. There are a number of different ways of structuring options, although Enterprise Management Incentives (EMI) options are often used.

**b) What is the disclosure letter and why is this required?**

The investment and shareholders’ agreement will contain a number of warranties relating to the business and affairs of the company. These will usually be given by the management shareholders and the company itself (the warrantors), in favour of the investor(s). If any warranties are not true, and this is not brought to the attention of the investor(s) prior to completion of the investment, the investor(s) will potentially have a claim against the warrantors for losses which they suffer as a result.

The disclosure letter, from the warrantors to the investor(s), is the document which details any exceptions to the warranties. It is an important document both from the perspective of the warrantors and the investor(s) for the following reasons:

- **From the warrantors’ perspective**, to the extent that exceptions to the warranties are “fairly” disclosed in the disclosure letter (i.e. in sufficient detail to enable the investor(s) to make an informed assessment of the matter in question), this should prevent a claim for breach of a warranty subsequently being brought against them.

- **From the perspective of an investor**, it fulfils a very useful confirmatory function in relation to the target business. As warranties and disclosure are key elements of the transaction documents and will be contractually binding on the parties, this can help to ensure that specific and detailed disclosures are made by the warrantors – as opposed to the often rather general responses which due diligence flushes out.

The disclosures usually fall into two categories, general disclosures (i.e. information which an investor will be deemed to have knowledge of whether or not it undertakes the necessary enquiries, such as information recorded at Companies House or the UK Intellectual Property Office) and specific disclosures against the warranties contained in the investment and shareholders’ agreement.

**c) Should I be insisting that the company signs a new service agreement?**

The investor is backing the people behind the business and will want to ensure that the terms on which they are employed by the company are clearly documented and offer appropriate protections to the company. Many companies do not put service agreements in place until they obtain their first external investment; where employment contracts are already in place investors often find that they are inadequate and need to be strengthened. Apart from the obvious commercial terms such as salary and bonus levels, investors will look for:

- A sensible notice period, ensuring that if a key member of management gives notice the company has a reasonable period of time in which to search for a replacement and that the period when the post in question will not be covered is minimised;

- Obligations restricting the disclosure of confidential information by the employee;

- Post-termination restrictions designed to protect the goodwill of the company (for example, restrictions on being involved in competing businesses or poaching customers or employees).

**d) Who will control the company on a day-to-day basis after the investment?**

The company will continue to be run on a day-to-day basis by the executive directors, with larger or strategic decisions being made by the Board. However, it may be a condition of the investment that the investor has the right to appoint a director to the Board, usually in a non-executive capacity. A fee may be charged by the investor for monitoring their investment in this way.
In addition, the Shareholders’ Agreement may specify certain actions which the company/board cannot take without the consent of the investor. These “consent matters” tend to include: the company borrowing more than an agreed limit; issuing new shares; adopting share option schemes; and taking actions which would jeopardise the investor’s EIS relief. Please see Schedule 6 of the BBAA Shareholders’ Agreement for a full list of consent matters that are commonly discussed. Matters requiring a resolution of the members will need to be put to the shareholders at a general meeting or by written resolution in the usual way, and of course both managers and the investor will be able to participate in these matters by virtue of their shareholdings in the company.

**e) What provisions of the Shareholders’ Agreement bind directly on the entrepreneur?**

The Shareholders’ Agreement is not just a contract between the investor and the company setting out the terms of the investment. The entrepreneur managers are almost always parties too. The obligations they assume are:

- To use their votes as directors and shareholders to ensure that the company abides by its obligations under the Shareholders’ Agreement;
- Alongside the company, to give warranties to the investor as explained in the answer to the question “what is the disclosure letter and why is it required”. Example warranties that may be sought by the investor are set out at Schedule 4 of the BBAA Shareholders’ Agreement;
- To ensure that the company provides the investor with key information, for example statutory and management accounts, business plans and budgets etc. An example of these information rights is set out at Part 1 of Schedule 7 of the BBAA Shareholders’ Agreement;
- To abide by restrictive covenants. As well as any restrictive covenants in the managers’ employment agreements, the Shareholders’ Agreement is also likely to contain similar restrictive covenants, but here given to the investor rather than the employing company. It is also likely that the courts will enforce restrictions in a Shareholders’ Agreement more readily than those in an employment agreement. These restrictions will cover non-competition, non-solicitation of employees and non-solicitation of customers, as set out in Schedule 8 of the BBAA Shareholders’ Agreement.

**f) For how long will the Shareholders’ Agreement stay in place?**

The Shareholders’ Agreement is likely to bind each of the parties to it for as long as they remain shareholders. Even after a manager ceases to be a shareholder they may still remain bound by provisions such as confidentiality, restrictive covenants and potentially the warranties.

The Shareholders’ Agreement will usually only terminate in its entirety upon a sale or listing, when all of the existing shareholders achieve an exit.

Most investors have a time horizon for their investment and managers should be aware that many Shareholders’ Agreements contain provisions that the managers will assist the investor in achieving a sale or listing of the company if an exit has not been achieved within a certain period from the date of investment, for example, those set out at clause 11 of the BBAA Shareholders’ Agreement.

**g) What are the Articles of Association and what key commercial issues do they contain?**

Unlike the Shareholders’ Agreement, the Articles are not a contractual document signed by all the parties. They are in fact the constitution of the company, in accordance with which the company has to act. They are binding on all of the shareholders as the “rules” of the company, of which each shareholder is a member. The precedent BBAA Articles of Association can be accessed at www.bbaa.org.uk.

The Articles may cover some of the provisions which are also dealt with in the Shareholders’ Agreement. For example, it is not unusual for both documents to deal with the right for the investor to appoint a director, other board matters, and matter requiring investor consent.
The key commercial issues which would usually be found only in the Articles are: Anti-dilution protection, compulsory transfer provisions (including good leaver/bad leaver) and forced exit provisions (drag-along and tag-along).

(h) What sort of anti-dilution protection can I expect to see in an Angel-backed deal?
Anti-dilution protection is the name given to provisions, usually in the Articles, to protect an investor from suffering dilution of his/her shareholding, which would otherwise occur when additional shares in the company are issued after the date of such investor’s investment.

Such protection can take the form of a ratchet mechanism which retrospectively re-prices the investor’s investment if further shares are issued by the company at a lower price, but more usually in Angel-backed business, anti-dilution protection takes the form of pre-emption rights over the issue of new shares, such that no new shares can be issued until they have first been offered to the existing shareholders, pro-rata to their existing shareholding. An example of such pre-emption rights is set out at Article 5 of the BBAA Articles of Association. In addition the issue of new shares is likely to be an action for which investor consent is required.

(i) Will managers be forced to sell their shares if they cease to work in the business?
It is very typical for investors to require managers to sell their shares in the event that they leave the business. It is generally thought that allowing individuals who no longer have a relationship with the company to remain as members makes the administration of shareholder matters more difficult and may be an obstacle to an exit. In addition, it is felt that there is no reason why a manager should benefit from further increases in the value of a business that they are not contributing to by working in that business.

If a manager’s shares fail to be sold, the price at which such sale occurs must be set. Angel Investors commonly make a distinction between managers who have chosen to leave (for example, to pursue an opportunity elsewhere, or to take early retirement) and those who have been forced to leave (for example, through ill health, redundancy or death). The former, referred to as “bad leavers” may be required to sell their shares at the lower of fair value and the price the manager originally paid for such shares. As managers tend to subscribe for their shares at par, a “bad leaver” price could therefore yield very little by way of consideration.

A price paid to a “good leaver” is likely to be market value. Assuming this is higher than the original price paid by the manager, that manager will therefore get their share of the increase in the value of the company which they have helped to achieve before their departure. Example “good leaver” and “bad leaver” provisions are set out at Article 10 of the BBAA Articles of Association.

(j) Other than cessation of employment, in which other circumstances can a manager be forced to sell?
Investors often require the ability, when selling their own shareholding in the company, to require that the managers also sell their shares to the same acquirer. The rationale for this is that many more purchasers are likely to be interested in acquiring the shares if they can buy the whole company, rather than a minority interest in it. This right, known as “drag-along”, usually means that the managers will get the same price per share as the investor.

Whilst some managers baulk at the prospect of being forced to sell “their” company at a time other than their own choosing, in reality, prospective purchasers will not be interested in buying a company in the teeth of fierce opposition from management. The process is inevitably more consensual than the mechanism of the drag-along may suggest.
Drag-along rights are also softened by the offering of equivalent “tag-along rights” giving managers the right to sell alongside the investor in the event that the investor has found a buyer for their shares, and has not invoked the drag-along. Example “drag along” and “tag along” rights are set out at Article 9 of the BBAA Articles of Association.

3. Intellectual Property (IP) considerations

Getting proper IP protection in place can be crucial to a company in ensuring that competitors cannot freely take advantage of the company’s innovations. IP protection can take a number of forms, including patents in the case of technical inventions; trademarks to protect a brand; design rights and copyright; and confidential information. Moreover, it is important to understand if IP owned by third parties may be relevant to a company’s activities, and if so the risks to the company that are posed by that third party IP.

The following IP due diligence questions are designed to give an understanding of the value of a company’s IP to the business as a whole, and the risks posed to the company’s business by IP owned by third parties.

The most important due diligence questions to ask will vary from one investment opportunity to the next, and may give rise to further questions beyond those set out below. Consequently, it is important to seek professional legal advice on a case by case basis.

3.1 General IP Considerations

The questions in this section should be answered for all IP that the company has rights to, regardless of whether the company owns the IP (in whole or in part) or is licensed under that IP.

(a) What intellectual property rights does the company hold rights to?
This includes patents, trademarks, registered designs and applications for the same; copyright material (e.g. software, brochures, manuals and details of databases), unregistered design rights and confidential information (in particular technical information that the company has chosen to keep confidential rather than publish).

(b) Does the company have an IP policy?
This is important in determining how the company goes about identifying, recording and protecting its intellectual property. For example, the company may have important IP that has not been identified (e.g. due to lack of IP awareness training) or that has not been protected (e.g. an invention may not have been filed as a patent application for budget reasons).

It is also important to understand what procedures the company has in place to deal with confidential information that has been provided to the company, or confidential information that the company has provided to third parties.

(c) What areas does the company’s IP lie in?
This question serves to understand who are likely to be direct and indirect infringers.

(d) For each registered right, is the right a pending application or is it a granted right?
Only granted rights can be enforced in the courts; although it may have value as a saleable asset, an application for an intellectual property right can not be enforced.
(e) What is the geographical scope of IP protection?
If the scope of IP protection is geographically limited then third parties are free to use that IP outside protected jurisdictions. For example if patent protection exists in the US only. Also, the ability to enforce IP rights effectively does vary from jurisdiction to jurisdiction.

(f) Is the IP relevant?
Is the IP relevant to:
(i) the company’s current activities; or
(ii) the activities of third parties?

An application for an IP right may have broad, commercially relevant scope but the corresponding granted right is often narrower and may not be as commercially important.

The following are key considerations when making an investment about assignment of IP to a third party.

(g) Does any third party have a right or interest in any of the company’s intellectual property, for example by way of a licence or a security agreement?

(h) Is the company prohibited from assigning any IP that it has rights to, for example under the terms of a loan agreement?

(i) Will purchase of the company result in termination of any provision in an agreement relating to IP rights that the company has with a third party?

Questions (g) – (i) are important in determining the freedom the company has to sell or licence its IP. Additionally, if there are change of control restrictions on third party software used by the company this will need to be addressed as, from the investor’s perspective, it may have a material impact on the value of the transaction.

(j) Has any of the company’s IP been the subject of threatened or actual litigation?
This includes but is not limited to:
• Alleged invalidity (for example, through opposition, interference, revocation or re-examination proceedings);
• Alleged infringement of the intellectual property (for example trade mark, copyright or patent infringement, passing-off or breach of confidence);
• Entitlement disputes;
• A claim by an inventor for compensation in respect of a patent or patent application owned by the company.

It is important to know if there is any actual or threatened litigation associated with the company’s IP, which may incur significant costs and/or put the validity or ownership of the company’s IP in doubt.

(k) What are the annual costs for maintaining all registered IP, including official fees and agents’ fees?
Filing and maintaining registered IP can be vitally important, but can also be expensive – it is important to know the cost of this IP protection in order to understand cost vs. benefit of the company’s IP protection.
3.2 IP owned by the Company
(a) In the case of intellectual property rights owned by the company, what is the basis for the company’s ownership?
This will usually be by way of an employment agreement assigning rights to the company as employer of the inventor, or an assignment in the case of IP that the company has acquired from a third party. It is important to note that IP generated by a consultant or contractor will not automatically vest in the company.

(b) Are there any restrictions on the company’s rights to use or licence its owned IP?
The company may own IP, but may not have the right to use or licence it - for example as the result of exclusive licensing arrangements.

(c) Are there any registrable IP rights for which applications have not been filed, in particular IP disclosures?
This question serves to identify potentially important IP that has not yet been protected.

3.3 IP arising from collaborations
(a) Copies of all agreements relating to collaboration with third parties should be provided.
This includes university collaboration or sponsorship, consulting, joint development, joint venture and non-disclosure agreements.

(b) Identify all IP arising from these collaborations.

(c) Are there any restrictions on the company’s right to use IP arising from collaborations?

(d) Are there any joint ownership issues that require consent of the third party for the company to exploit the IP?

(e) Does the company have the right to grant licences to IP arising from collaborations?
For example, the company may be a sole or joint owner of a patent arising from a collaboration, but the collaboration agreement may divide use and licensing rights, for example, by technology field.

3.4 IP licences
(a) Does the company have licences to third party IP? Provide copies of all such licences
This should include licences to "off-the-shelf" software such as Microsoft Office, in addition to licences more directly related to the business of the company.

(b) Has the company either:
i) licensed IP that it owns in whole or in part, or
ii) sublicensed third party IP? Provide copies of all such licences.

(c) It is important to understand if the company has restricted its rights to use or licence IP it has rights to.

3.5 Infringement
(a) Has any of the company been alleged to infringe third party IP, and if so has there been any threatened or actual litigation?
(b) What clearance searches and opinions does the company have?

(c) What searches and analysis have been conducted with respect to the IP position of competitors?

It is important to ascertain if competitors hold key IP that the company would need access to.

(d) Has the company given any third party a representation, warranty or indemnification with respect to infringement of third party IP?

(e) Has any third party been alleged to infringe IP owned by or licensed to the company, and if so has there been any threatened or actual litigation?

This does not have to be formal legal notification. For example a third party may have sent an e-mail or notified the company by telephone. All such instances should be recorded and information regarding them provided.
As an investor, you would normally wish to take a strategic interest in the development and growth of the investee company. You may wish to take a seat on the Board or take a specific role within the management. The following considerations would apply following an Angel Investment:

1. **What are the legal and regulatory considerations when an Angel sits on the Board?**

An Angel Investor sitting on the board of an investee company needs to be aware that they will become subject to a significant number of duties imposed by law. Directors are currently subject to seven general duties set out in the Companies Act 2006, being:

- To act within their powers;
- To promote the success of the company for the benefit of its members as a whole;
- To exercise independent judgement;
- To exercise reasonable care, skill and diligence;
- To avoid conflicts of interest;
- Not to accept benefits from third parties;
- To declare interests in proposed transactions or arrangements.

These duties co-exist alongside one or two remaining fiduciary and common law duties, which were largely replaced by the statutory duties. In addition, directors are subject to many other specific duties imposed by legislation.

These specific duties include a large number of administrative obligations imposed by the Companies Act 2006, as well as duties imposed by environmental and health and safety legislation. Directors also need to be aware of the Insolvency Act 1986, particularly the “wrongful trading” provisions, which can impose liability on a director where a company continues to trade in circumstances where the director knew, or ought to have known, that there was no reasonable prospect of the company avoiding insolvent liquidation. Breach of many of these duties is a criminal offence.

There are a number of very important points which an Angel director taking up a board position should be aware of:

- The law relating to directors’ duties does not distinguish between executive and non-executive directors. However, in applying those duties account will usually be taken of the fact that a non-executive director has a more limited involvement with a company than the executive team;
- Directors owe their duties to the company as a whole. They should not therefore seek to prefer one group of shareholders over another. Since an Angel will be appointed to ensure that the interests of the investor group are represented, it is important not to lose sight of this point;
- An Angel Investor should explore whether it is possible for directors’ and officers’ insurance cover to be put in place covering the board as a whole.
- In certain circumstances EIS income tax relief can be lost if an Angel takes up a board position for which they are remunerated or are entitled to be remunerated. If the company in question is seeking to take advantage of EIS relief and it is proposed that an Angel be appointed to the board, this issue will need to be reviewed carefully.
2. What are the legal and regulatory issues involved in an Angel Investment exit?

An exit is the process by which Angels may (hopefully!) realise a substantial capital gain by selling their shares in the investee company for a higher value than their initial investment. The three main types of exit event are as follows:

(i) The sale of the entire issued share capital to a third party, often a trade purchaser, although occasionally by way of a “buy-out”, where the investee company is acquired by an entity funded by a private equity investor, a bank and/or a management team;

(ii) The buy-back of the Angel’s shares by the company itself from its own resources, or perhaps by a fellow investor or by the entrepreneur; or

(iii) The flotation of the company on a public market, such as the Alternative Investment Market (AIM), by way of an initial public offering.

In each case, these will be critical events for the Angel Investor and will give rise to a considerable number of legal issues, a selection of which are outlined below. It is therefore vital for Angels to obtain, either independently or as part of the wider seller group, the best legal advice from lawyers who are experienced and skilled in these types of transactions so that the prospects of achieving the desired financial return from the exit are maximised and ongoing risks are minimised.

2.1 Sale to a third party

Firstly, the Angel should fully understand the nature of the proposed deal and ensure they are happy with the way it is structured. Key questions are likely to be:

• Will the consideration be fully paid at completion, or is there an element of deferred consideration, for example, an earn-out?

• Is the buyer proposing a retention fund, through which some of the consideration is reserved to deal with post-completion issues, for example, warranty claims?

• Is the consideration all cash, or is the Angel (and their fellow sellers) being offered loan notes or shares in the buyer (the creditworthiness or value of which could change after the deal completes)?

These issues go to the core of whether the deal will actually deliver the anticipated return on investment and need to be carefully evaluated at the outset.

On the basis the Angel is happy with the proposed deal, the key transaction document will be the sale and purchase agreement between the Angel, their fellow sellers and the buyer. This will contain a number of contractual protections in favour of the buyer which need to be considered and negotiated carefully. The buyer is likely to require a fairly comprehensive set of warranties, which are contractual promises about the state of the business, for example, that it is not involved in any litigation, which if later proved to be incorrect when given, enable the buyer to sue for damages if they have suffered loss (i.e. the value of the company is diminished). If the Angel has not been closely involved in the investment, warranties may be difficult for the Angel to provide, since their knowledge of the business will be based only upon the information provided by the management team. There is a natural tension between Angels wishing to limit their contractual risk (i.e. by not giving warranties where they feel unable to do so) and purchasers wishing to have contractual recourse for the full amount of the purchase price. This is where the position of the Angels and the management team can begin to differ and careful consideration (and possibly independent advice) will be needed to resolve this issue.
Another area of possible tension is restrictive covenants – a buyer may demand an undertaking from all sellers that they will not, for a period following completion, compete with the business or solicit its customers, suppliers or employees, or indeed invest in a competing business. Whilst this may be viewed as a reasonable request for the management team, who clearly have the potential to undermine the goodwill acquired by the buyer if they engage in such activities, the Angel Investor will not want to be “locked out” of a particular sector if they feel this is ripe for further investment, or if it is the sector they always invest in as it matches their own area of expertise.

2.2 Buy-back of shares
If a third party purchaser is not yet available or the other shareholders do not wish to sell at that time, the Angel can achieve an exit through having their shares acquired by the company itself. However, the company can only legally do this by:

(i) Funding the acquisition through its retained profits;
(ii) Funding the acquisition through the proceeds of a fresh issue of shares (i.e. a new funding round);
(iii) Having exhausted its retained profits and in limited circumstances only, funding the buy-back out of existing share capital.

The company will therefore need to be on appropriate financial footing in order to effect this type of transaction, and the entrepreneurs leading the venture may be reluctant to divert company funds to an Angel seeking an exit if funds are still needed to finance growth.

Alternatively (or possibly in conjunction with a buy-back), the Angel can sell their stake to existing investors, for example, the management team, who may be prepared to buy the shares now in anticipation they can be sold at a higher price at a later stage. The company’s articles of association will usually require the Angel to make an offer to all shareholders to purchase their shares, with their entitlement being determined by the size of their existing holding.

The Angel would likely only be able to sell their minority stake to an independent third party if rights of pre-emption were not taken up or waived by the existing shareholders. In any event, the acquisition of a minority stake in a private company is unlikely to be appealing to anyone who is not already a stakeholder in the business.

2.3 Initial Public Offering
If the company is of sufficient size and strength, the shareholders may seek to convert the company to a public limited company and arrange for it to be listed on a public market by way of an initial public offering (IPO). In the UK, these markets are generally either the Official List of the London Stock Exchange or the Alternative Investment Market (AIM), with AIM being the most likely exchange for the IPO in light of its less demanding regulatory regime and suitability for small capital companies.

An IPO should deliver a number of benefits to the company such as increased profile, additional money for expansion (since new shares are likely to be issued as part of the IPO) and future acquisition currency, as it will be able to issue publicly traded shares as currency to fund transactions. However, Angels should note that an IPO is unlikely to deliver the full “exit” they may be seeking - the immediate sale of shares by those closely associated with the company will send out a signal to the markets that the company is overvalued, leading to a decline in share price and unhappy investors. As a result, existing shareholders will be subject to a “lock-in” period in which they are restricted from selling their newly liquid shares. This is likely to be more onerous for the management team given their more detailed knowledge of the state of the business, although will depend on market conditions and is a key issue for Angels seeking a true “exit” by way of an IPO.
About the British Business Angels Association

The BBAA is the only trade association dedicated to promoting Angel Investing and supporting early stage investment in the UK. Each year private investors account for between £800 million and £1 billion of early stage investment in the UK: the single largest source of early stage capital in the country.

The BBAA works to create an eco-system to promote and support the early stage investment market, providing a forum for these groups to integrate and share good practice on new developments and trends in early stage investing, development of new services and tools to support the investment process. The BBAA also acts as a voice to Government, stakeholders, business and the media to promote the interests and needs of the Angel and early stage investment industry.

The BBAA was created in 2004 and receives some support from the UK Government. It has a growing membership consisting of 25 Business Angel Networks, 20 early stage venture capital funds, and over 30 professional advisory businesses, policy makers and academics.

The BBAA is driven by a Board of high calibre individuals from within the industry and supported by a network of four Committees whose membership comes from within BBAA, meaning that members have not only a voice in the direction of the association, but also help drive forward and shape BBAA policy.

If you would like more information about the BBAA or would like to become involved with the Angel Investing Awareness Campaign, please contact us.

Email: info@bbaa.org.uk; Tel: 020 7089 2305; Web: www.bbaa.org.uk