



---

## **LEGAL OVERVIEW OF EQUITY INVESTMENT**

Oglethorpe Sturton & Gillibrand

TUESDAY 14 APRIL 2009

## Seminar Notes for Delegates

### Talk to Chamber of Commerce- 14 April 2009

Introductory Note: The talk and these notes do not offer advice in relation to any particular transaction or individual situation. These should be discussed with a qualified legal advisor and for further information please contact us at:

Oglethorpe Sturton & Gillibrand, 16 Castle Park, Lancaster LA1 1YG  
( t: 01524 846846 f: 01524 382247

Summary of Talk	Delegate Notes
-----------------	----------------

## **EQUITY INVESTMENT**

Every owner of shares whether in a small family company or in a large listed PLC is an equity investor and has rights attached to the shares that he owns. How he views that investment may vary according to circumstances and we will look at some of the issues today.

### **Some initial considerations**

- Equity or Debt?
- Something a little in-between (preference shares)
- Risk and reward
- Marketability (Table A directors absolute discretion)
- Control
- Gearing
- Tax (partnership or company)
- Anti-dilution
- Security and priority
- Health Warnings

### **Smaller Companies - Shareholder Arrangements**

#### **The role of the shareholders agreement and articles**

- The shareholders agreement.
  - Equal or unequal shareholdings?
  - Does the majority shareholder need protection?
  - Deadlock companies (both minority shareholders)
  - Classes of shares with attached rights to appoint directors
  - Mechanism for veto rights and control for minority shareholders through 'reserved matters'
  - Restrictive covenants
  - Supply contracts where shareholders supply goods and services to the company
  - Disputes and their resolution
    - Texas Shoot-outs
    - Russian Roulette
    - Winding up
    - Toss of the coin
  - Appointment of directors
  - Additional loans by shareholders
  - Management, the Chairman (casting votes) and quorum
  - Sale of shares where breach of agreement
  - Dividend policy
  - Life assurance
  - Directors and officers insurance
- Articles of Association
  - Setting out the share rights

- Dividend
- Voting
- Return of capital
- Directorship
- Redemption
- Conversion
- Class rights
- Transfer provisions
  - 'privileged relation' class- tax planning
  - Pre-emption rights
  - Mandatory transfer on death, leaving the company (tensions between working and non-working shareholders)
  - 'drag along'
  - 'tag along'
  - Ratchets ( see private equity)

**EIS (Enterprise Investment Scheme)- tax relief**

EIS is a government business expansion scheme introduced to encourage equity investment in new and small companies. The EIS has been available for investments since 1994. Taxpayers can benefit from unlimited deferral relief from capital gains tax where gains (including gains on shares) are reinvested in newly issued eligible shares (*section 150C and Schedule 5B, Taxation of Chargeable Gains Act 1992*). The investment in eligible shares must occur within the period beginning one year before and ending three years after a gain is realised. The gain is then postponed and becomes chargeable only on the occurrence of one of several specified events, for example, on the disposal of the EIS shares or the shares ceasing to be eligible EIS shares. Taxpayers are also entitled to relief from income tax on investment in EIS shares. The income tax deduction is given at the rate of 20% on the amount invested, up to a maximum annual investment of £500,000, provided that the shares are held for at least 3 years. Broadly, a company's shares will be eligible for the EIS if it is an unquoted trading company with gross assets (including subsidiaries' gross assets) not exceeding £7 million, and its trade (or a substantial part of its trade) does not consist of one or more excluded activities. These include dealing in land, banking, financial services, leasing, and legal and accountancy services (*section 297(2), Income and Corporation Taxes Act 1988* for periods before 2007-2008 and *section 192, Income Tax Act 2007* thereafter).

### **Entrepreneurs Relief (introduced after abolition of taper relief)**

- More than 5%
- Individuals only
- Lifetime gains up to £1,000,000
- Effective 10% relief
- 'qualifying business disposals'
- Held shares/interest in business more than 1 year

### **Private Equity/ Venture Capital**

Private equity transactions, formerly more commonly known as venture capital transactions, cover a variety of arrangements that have one common feature: the source of the money that is funding the transaction. This source is usually a fund established to invest specifically in unquoted securities (private equity) rather than in publicly quoted securities or government bonds.

Funds established to invest in private equity transactions obtain their money from a variety of sources, including institutions (such as pension funds, banks and insurance companies), companies, individuals and government agencies. According to the British Venture Capital Association (BVCA) approximately £34.3 billion of private equity funding was raised by BVCA members in 2006 (up from £27.3 billion in 2005), with 72% coming from overseas sources (compared to 79% in 2005) and North America being the largest contributor with 37% of the funds raised (see BVCA Report on Investment Activity 2006: summary of results ([www.practicallaw.com/1-200-8249](http://www.practicallaw.com/1-200-8249))). **(Data from Practical Law)**

- Start-ups.
  - Minority stake
- Development capital.
  - Minority stake
- Buyouts.
  - Management buyouts (MBOs) - where the existing management team buys out the business it manages.
  - Management buy-ins (MBIs) - where a team is assembled for the purposes of making an acquisition.
  - Buy-in/management buyouts (BIMBOs). A hybrid, combining an existing management team with an external management team.
  - Institutional buyouts (IBOs) - where a private equity fund sets up a company to acquire a business (perhaps even an under-performing listed company) and gives management a small stake either at the time of the buyout or after its completion.
  - Often a majority stake is taken

### **Risk Capital**

- High tech companies
- Dot.com bubble
- Priority
- IRR (internal rate of return) This is a compound rate of interest worked out over the life of the fund, which takes into account when money was paid in by investors and when they receive their return. Since an investment in unquoted securities is a relatively high risk investment, the returns expected by investors are high.

### **Directors Duties in a buy**

- duties of confidentiality that they owe to their employers (for example, by disclosing financial information or trade secrets to potential funders).
- service contracts duties (for example, failing to devote their energies to the business of their employer as a result of spending their time trying to pursue a buyout).
- obtain their employer's permission to pursue their objectives. The employer's permission usually involves granting a waiver of any breach of service contract that would otherwise occur. Clearly, the employer can remove this waiver at any time and require the managers to desist from pursuing the buyout.

### **Who are they?**

- Lancashire Rosebud Fund (Lancashire County Council Funds)
- BVCA Handbook
  - Captive (in house from banks or other institutions)
  - Independent private equity and hedge funds

### **What's in it for them?**

- High rate of return (successful investments need to outnumber unsuccessful ones)

- Exit
  - Sale
  - Flotation
  - Winding up
  - MBO etc
- When will the exit be planned?

### **Regulation of private equity**

- The Financial Services Authority
- BVCA Guidelines for disclosure and transparency in private equity

### **Safeguarding the Investment**

As with any other shareholder the private equity investor safeguards its investment through the shareholders agreement/investment agreement/subscription agreement and through the Articles.

- Veto powers
- Fees
- Borrowing powers
- Directors and observers
- Key man insurances
- Warranties
- Due diligence
- Debt to equity conversion (equity kickers)
- Warrants (options to subscribe further shares)
- Control of further investment

### **Business Angels**

Jenny Gemmell: [jenny.gemmell@osg.co.uk](mailto:jenny.gemmell@osg.co.uk)

Alison Kinder: [alison.kinder@osg.co.uk](mailto:alison.kinder@osg.co.uk)

David Park: [david.park@osg.co.uk](mailto:david.park@osg.co.uk)

Andrew Royce: [andrew.royce@co.uk](mailto:andrew.royce@co.uk)