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# What does it take for an investment to work well through to exit?

19th January 2021



**Catherine Gannon of [Gannons Solicitors](#) looks at how to ensure a smooth relationship between investors and entrepreneurs.**

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concerned with ensuring that the business is a good investment and putting in place measures to protect their investment.

Companies and Angels will often come to us with heads of terms and this is usually where the legal work starts. The main legal documents are usually the articles of association and an investment agreement. On larger investment deals we will be involved from the start of the process and review the heads of terms as well.

The more shareholders there are in the company prior to the investment, the more complicated the practicalities of negotiating an investment deal can become. Family, friends and staff will not want to give warranties and will be much more difficult when negotiating changes to share rights, preferences and controls in favour of the Angel.

Managing the parties involved becomes one of the biggest parts of the lawyers role. Passions run high but can be unrealistic. Most Angels will have a certain amount of flexibility before adopting any hard lines, similarly founders will be as appeasing as they can before they get to terms that will break a deal.

## Articles of Association

First we take the articles, where all of the corporate rights are dealt with.

The parties may have discussed sale preferences, voting rights and dividends but there are a number of other corporate matters that will need to be negotiated.

Angels will often require an entrenched right to have a representative on the board of directors and, depending on the size of their investment, more than one director on the board. We have experienced a real push back on any investors weighting the board in their favour and protracted negotiations over quorum for the board, to ensure that an Angel can not frustrate the decisions of the Company by refusing to attend meetings. We have had a client agree five alternate quorum options for their board, each depending on different circumstances to ensure there is protection for the Angel without ultimate frustration of the business.



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and require a much higher level of bespoke drafting. Things to think about are whether an Angel should have the right to get shares before other shareholders, whether the Company should have rights to buyback before everyone else, and grouping of types of shares (e.g. non-voting shareholders only get rights of pre-emption in non-voting shares, employee shareholders only get rights of pre-emption in employee shares)

## Transfers

Permitted Transfers and Compulsory Transfers can be sources of contention, most Angels will want permitted transfers (which are outside the usual pre-emption rights) to allow them to restructure or transfer relatively freely without triggering the rights of first refusal of other shareholders. Individual shareholders will often want to be able to transfer to their family for estate planning purposes, an Angel will want this as restricted as possible for shareholders and as wide as legally possible for themselves. Startup companies and smaller businesses will have much more to say about who they are getting into bed with and careful drafting will be needed to get everyone comfortable.

## Leaver provisions

Leaver provisions can break these deals, Founders will not usually have contemplated that if they leave their shares must be sold (usually back to the Company) and will be even more aggrieved that they may receive no value if they become a so called “bad leaver”. The definition of good and bad leavers can therefore be a minefield to agree. We have seen both ends of the spectrum in the definition of bad leaver from the completely restricted ‘fraud and dishonesty’ being the only grounds to be classed as a leaver to being as wide as anyone who has not died or become incapacitated. We are seeing more often ‘intermediate’ leavers, where a middle ground can be agreed so that full market value is not realised but some value can be attributed to the shares, for example the price per share paid by the Angel. Another alternative is that the value attributed grows over time, so that someone who leaves after several years is not necessarily classified as a bad leaver.

## Investment Agreement

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## Warranties

Warranties are common and not usually contentious, save for small carve outs relating to the warrantors knowledge, Angels will often not accept any changes to the warranties. The commercial trade off for this is the disclosure letter (discussed below) and limitations on liability. Again, these provisions are often hard fought, the Angel wanting as much right to bring a claim as possible and the Company (and mainly those individuals giving the warranties) will want as many limitations on such liability as possible. The fundamental limitations for any claims will usually include a financial limit (often being the investment amount) and a time cap for bringing claims. Where the Founder is personally giving warranties we would argue that the financial limit should be very low, certainly no more than a year's salary.

## Employees

It will often be fundamental to an Angel's protection that the Founders and any key staff are incentivised to stay and (if possible) tied in. Two fairly typical considerations are to grant EMI options often only kicking in on an exit. The other consideration is that Angels will often require restrictive covenants to be put in place to protect against non-solicitation, non-dealing and non-poaching clauses for clients and key staff. The non-compete clause restricting a person working for a similar or competing business is difficult for Founders and their employees to accept. Expect push back on anything that restricts trade for too long and on too wide a basis.

## Veto powers

Angels will often want various corporate and commercial veto powers to stop Companies carrying out certain actions without their consent. The degree of power given to the Angel will usually depend on how much equity is being taken by them. The usual reserved matters tend not to be too contentious, e.g. amending articles of association, changing the nature of the business, borrowing money, issuing shares, commencing winding up or buying or selling assets other than in the ordinary course of business. Practically, companies will normally want the investor director to be able to sign off on these matters without having the

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business without going to the Angel for consent, it becomes impractical and cumbersome. Angels should therefore think about the areas where there is specific concern for example requiring a veto on any increase in director remuneration rather than on any staff salaries.

## Due Diligence and Ancillaries

Alongside the negotiation, there will be a due diligence process, whereby the company is required to present the company documentation for the Angel to assess risk. This can be undertaken lawyer to lawyer or Angel to Company. It is a heavy admin task on both sides of the transaction, for the Company in preparing the data rooms and for the Angel in assessing risks. Due Diligence will usually start before the legal documentation is drafted but can at times take longer than the documents to agree, depending on the level of organisation of the Company's files and nature of proverbial skeletons in the closet. Tied into this process is the disclosures against the warranties in the disclosure letter, a number of the documents produced in due diligence will then also be disclosed in the disclosure letter. Company's often underestimate the importance of disclosures, especially once due diligence has been concluded thinking that everything has already been provided to the Angel. However, depending on how restrictive the liability provisions are, documents in the data room may not be sufficient and specific disclosures may be required.

The final step is the ancillaries, board minutes, shareholder resolutions and Companies House forms, these are the lawyers' bread and butter and will authorize the entire transaction and update all of the company's records. We have to check what approvals the company needs and what percentage of shareholder approval will be required. They are not often contentious in nature but are crucial documents to the transaction. These will also include any new service agreements for Founders and possibly commercial arrangements that are part of the deal.

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