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Venture capital in the US and UK – a comparison

The increasing number of innovative scale-up companies and the UK's ability to attract world class talent means that the UK is an attractive destination for investments by US venture capital funds (**US VCs**). In turn, this means that US VCs have become an increasingly important source of capital for UK based high growth businesses.

Venture capital funds in the US and UK are typically structured as limited partnerships investing in early-stage companies alongside other investors in the form of preferred equity or convertible instruments. The typical UK venture capital investment usually involves the investor acquiring equity in a private company in return for cash. The investor usually acquires a class of preferred shares which give a priority right to receive payments if the company is sold, liquidated, or wound up, and often a cumulative dividend. In addition, the investors are given various rights by the company including the right to receive financial and other information in relation to the company, board membership and certain rights on "exit" events including a public offering or sale of the company.

However, there are some key differences between the UK-style and US-style transactions in terms of the legal process, investor protections and the style of documentation and terminology. This note sets out a comparison of some of the key differences between the US and UK VCs, the terminology used in transactions and differences in key transaction documentation.

Industry Bodies

Both the UK and the US have industry bodies the British Venture Capital Association (**BVCA**) and the National Venture Capital Association (**NVCA**) respectively. The BVCA and NVCA have both produced template documents designed to standardise the approach and documentation used in early-stage transactions.

Key transaction documents

One of the main differences between UK and US VC transactions is in the transaction documentation. In the UK, the principal legal documents for a traditional investment round are a subscription and shareholders agreement (sometimes referred to as an investment agreement); a disclosure letter; articles of association and management service agreements.

In the US, the key transaction documents for a traditional fundraising will vary depending on whether the investment is being made into an LLC or a corporation, but may include a stock purchase agreement and a schedule of disclosures or exceptions; amended and restated certificates of incorporation; stockholders' agreements (including investor rights agreement, right of first refusal and co-sale agreement and voting agreement); registration rights agreement; management service agreements; certificate of incorporation and by-laws.

In the UK, the investment agreement generally includes the provisions contained in the US stock purchase agreement, right of first refusal and co-sale agreement, voting agreement and investor rights agreement and, where appropriate the registration rights agreement. In the UK the investment agreement is sometimes split into two separate agreements - a subscription agreement and shareholders' agreement - this avoids littering the investment agreement with provisions that are not relevant to the ongoing operation of the company. The articles of association are the UK equivalent of the US certificate of incorporation and by-laws.

Typical investment periods

In the UK VC funds typically invest money raised in three to five years and seek to realise their investment before the end of the life of the fund which is usually ten years. This contrasts with the position in the US where the investment period is usually dependant on the sector in which it is invested. In addition, US VC funds typically have a fund life of between eight and 12 years.

Tax

In the UK, the Enterprise Investment Scheme (**EIS**) and Seed Enterprise Investment Scheme (**SEIS**) offer tax relief on income and capital gains to qualifying investors, subject to certain conditions on the type of and duration of holding of shares in qualifying companies.

The EIS and SEIS schemes are important to the UK market and underpin the investments of numerous angel investors and EIS/SEIS qualifying funds. To qualify for EIS and SEIS tax regimes in the UK the relevant shares must be full risk ordinary shares (this means that they cannot be redeemable or carry any special of preferential rights other than limited preferential rights to dividends. For further information on the EIS and SEIS schemes see SEIS investment guide and EIS investment guide.

In the US, the position varies from state to state, with some states offering venture capital tax credits. At national level, the qualified small business stock permits investors to exclude a percentage of the gains made on the sale of qualifying stocks after five years.

Warranties

In the UK, the investment agreement usually includes a series of warranties about the target company and its business; these warranties are generally given by the target company, and often also by its founders. If the founders do give warranties, it is also typical for their liability to be capped, usually at a multiple of their salary. It is not customary for warranties to also be representations in UK-style investment rounds this is because it opens the possibility of a claim for misrepresentation which may give rise to the right of recission and to a tortious claim for damages rather than for pure contractual damages.

This contrasts with the position in the US where it is standard for the warranties in the stock purchase agreement to be representations as well. In addition, the representations and warranties are usually given only by the target company; and it is unusual for the founders to give any representations and warranties.

For a further discussion on warranties and representations see US UK M&A Warranties.

Disclosure

In the UK, disclosures against the warranties are set out in a separate disclosure letter. The disclosure letter contains general disclosures (that is matters deemed to be within the investors' knowledge) as well as specific disclosures. The general disclosures are matters of which the investors are aware, and they serve to qualify the warranties – they include things such as information contained in the company's public record at Companies House.

In the US, disclosures against the warranties and representations are set out in the Schedule of Exceptions, which is part of the Stock Purchase Agreement. It is not customary to permit general disclosures in US style transactions, and US investors often resist general disclosures.

For a further discussion of the disclosure process see US/UK M&A: Disclosure.

Veto rights

It is common practice for both UK and US style investment agreements/stockholders' agreements to contain a list of 'reserved matters' over which the investor has a veto right; the list of reserved matters in UK transactions is often significantly longer than the US.

Registration rights

Registration rights are not usually a feature of UK investment rounds because a listing on AIM or the Main Market of the London Stock Exchange involves listing the entire issued share capital of the company, therefore registration rights for investors are less relevant. However, investors' rights in respect of a listing are often included in the exit provisions contained in the shareholders' agreement.

In contrast, registration rights are a standard feature of US venture capital transactions. A registration right is the right of the investors to compel the company to register shares. By creating liquidity, this right provides investors with an exit from their investment if they desire. There are two principal types of registration rights: demand rights and piggyback rights. Demand rights entitle an investor to compel a company to file a registration statement with the US Securities and Exchange Commission (**SEC**) covering the shares held by an investor. Piggyback rights entitle an investor to register its securities when either the company or another investor initiates the registration; piggyback registration rights are generally regarded as inferior to demand registration rights because holders of the piggyback rights cannot initiate (or demand) the registration process. Registration rights are particularly relevant to US investors, because unregistered shares can only be sold to a relatively small number of potential purchasers, in addition, a registration statement filed with the SEC is effective only as to the shares specifically identified in it - it does not serve to register all the shares of the company.

Anti-dilution

Anti-dilution provisions are commonly included in both UK and US documentation, it provides an investor with an enhanced economic position from the one it would have had if it suffered the full dilutive effects of a "down round". A ratchet mechanism is generally used to achieve this, often using a 'weighted average' basis.

In the UK the most common anti-dilution mechanic is a bonus issue of shares to compensate the investor for the dilution suffered in a "down round". However, in the US, it is more common for the conversion ratio of the investor's preference stock to be adjusted (by an increase) to compensate the investor's dilution suffered in a "down round".

Share retention

The management team is often a key component of a business' value, and investors in both UK and US venture capital transactions usually incentivise founders and key executives to remain with the company. Often investors require the founders and key executives to relinquish a portion of their share ownership if they leave the company. In UK transactions, the founders and/or key executives may be required to relinquish all of their shares in certain circumstances (so called "bad leaver" situations); this approach is less common in a US-style transaction.

Generally, the approach to share forfeiture provisions has been distinct between the US and the UK. US transactions usually impose a vesting schedule that specifies increasing levels of share retention the longer the individual remains with the company. In contrast, UK-style transactions provide for differing levels of share retention depending on the circumstances under which the individual leaves the company. UK documentation distinguishes between two broad categories of departing individuals: "good leavers" and "bad leavers". Then, within each of these categories, a further distinction is made so that, for example, an employee who resigns voluntarily is treated differently from one who is constructively dismissed, and one who is dismissed without cause is treated more favourably than one dismissed for cause.

Pre-emption rights on issue and sales of shares

In the UK, the Companies Act 2006 requires new issues of shares for cash to be first offered pro rata to existing shareholders. These provisions can be disapplied by shareholders in relation to a specific issue of shares or generally. Modified pre-emption rights are commonly included in the articles of association of a company. These may require that any shares not taken up by existing shareholders be offered again to other existing shareholders before being sold to a non-shareholder.

Because the laws of US jurisdictions may not grant shareholders pre-emption rights automatically, US transaction documentation usually provides for such rights. The pre-emption rights granted by these provisions in US-style agreements do not differ markedly from typical pre-emption rights in a UK-style transaction.

Both US and UK venture capital transactions typically include rights of first refusal on proposed transfers of shares. Rights of first refusal require a selling shareholder to first offer the shares to the company and/or the other shareholders. If the company and/or the other shareholders decline to purchase the shares, the shares can then be sold to non-shareholders (and even then, they may only be sold for the same price and on the same terms that the shares were offered to the existing shareholders).

Restrictive covenants

Investors often attempt to protect their investment, in particular to ensure that the founders and/or key executives do not leave the company and set up a competing business or poach employees or customers. A mechanism used to achieve this in the UK is restrictive covenants; these are often imposed on the founders and key executives in the transaction documents and any service agreements.

In UK-style transactions, investors often introduce new employment or service contracts for the founders or key executives that also include restrictive covenants on the activities of these individuals. In contrast with the provisions in the subscription and shareholders' agreement, the covenants in the employment or service agreements run in favour of the company rather than the investors. Separate provisions may also be included in the subscription and shareholders' agreement. Restrictive covenants in employment contracts are usually shorter in duration than those given to the investors in the subscription and shareholders' agreement because they are considered more difficult to enforce in an employment contract.

In contrast, restrictive covenants are requested less often in US-style transactions; partly because there are greater issues surrounding their enforceability in some US jurisdictions (such as California).

Simple agreement for future equity

An alternative to the traditional investment round for early stage and start-up companies outlined above is a simple agreement for future equity [**SAFE**). SAFEs were introduced by the start-up accelerator Y Combinator in 2013 and are widely used in the US for seed capital. A SAFE is a contract between the company and an investor that gives the investor the right to receive equity in the company on certain triggering events such as

future equity financing (usually led by a US VC) or the sale of the company). The price of the equity that the SAFE holders receive on conversion is lower than the price of the securities issued to VC investors in connection with the future equity financing round.

A similar mechanism to the SAFE is used in the UK, this is often called an advanced subscription agreement. The advanced subscription agreement enables start-up companies to raise cash ahead of a traditional investment round and the documentation is carefully drafted so as to be SEIS/EIS compliant for UK tax purposes.

Common language?

The UK and US often use different terminology in relation to venture capital transactions some examples include:

- Shares
- Ordinary shares
- Preference shares
- Tag along right
- Subscribe
- Article of association
- Stock
- Common stock
- Preferred stock
- Co-sale right
- Purchase
- Bye-laws

For more information on this subject please contact:

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