**SEED INVESTMENT AGREEMENT: DRAFTING NOTES**

**General**

In making a seed investment, there are usually two key documents:

* The principal contractual document is a subscription and shareholders agreement (often referred to as an investment agreement). This often takes the form of a single document but it may be split into two separate documents, a subscription agreement and a shareholders' or investors' rights agreement. [If using separate documents, please use the guidance notes specifically relating to those documents.] The investors' solicitors usually prepare the first draft of this agreement.
* The other key document is the new articles of association of the company in which the investment is being made (the "**company**"). The articles of association form part of the company's constitution and as such govern the internal management of the company's affairs. They will be subject to requirements of the Companies Act 2006 (the "**Act**").

**What is an investment agreement?**

The investment agreement will, unless issues have arisen during the due diligence exercise, reflect the provisions of the term sheet. Unlike the term sheet, all of the provisions of the investment agreement are intended to be legally binding.

The investment agreement will be made between:

* the investors;
* the management of the company; and
* the company.

It records the commercial terms of the arrangement between the parties and will include specific details of the investment round, including the number and class of shares to be subscribed for by the investors, payment terms and warranties about the condition of the company. The warranties will be qualified by the terms of a disclosure schedule which will refer to supporting documents (usually referred to as a "**disclosure bundle**") and will specifically set out any issues that the management and the company think the investors should know of, prior to completion of the investment.

**Should provisions be included in the investment agreement or articles of association?**

The parties should consider which provisions should be included in the investment agreement and which should be in the articles of association. The investment agreement binds only the parties to it; the articles of association bind all of the company's shareholders and the company.

However, it is common for the investment agreement to include a provision stating that, in the event of conflict between the articles and the investment agreement, the terms of the investment agreement shall prevail (*for an example, see clause 20 of the seed investment agreement*).

Generally, investment agreements will also contain provisions protecting the investors' interests. In addition to the warranties referred to above, these protections include rights to board representation, consent rights and non-compete restrictions (*see respectively, clause 8, clause 10 and clause 12 of the seed investment agreement*). The articles of association will include details of the rights attaching to the different classes of shares, the procedure for the issue and transfer of shares and the procedure for holding shareholder and board meetings.

**Parties**

This part of the agreement identifies the parties to the agreement.

The document assumes that the investment will be made by a number of investors participating in a syndicated investment. If the investment is syndicated, consider whether to appoint a lead investor to take charge of negotiating the terms of the investment.

If a lead investor is appointed, consider on what basis it is to be appointed and whether it, (rather than a majority of the investors, as in the seed investment agreement (*see Definitions: clause 1 below*)) should have the ability to take other key decisions under the agreement, (such as when to bring warranty claims).

If the investment is not syndicated, amend the parties clause by inserting the investor's details and delete part 1 of schedule 1 of the seed investment agreement. Consequential amendments will also be required throughout the document for example, the definition of "Investor Majority" in clause 1 will not be necessary. In such circumstances, consider whether some or all of the decisions reserved to an investor majority should require the investor's approval instead.

The managers are listed in part 2 of schedule 1 of the seed investment agreement. They are likely to include the company's founders and some (or all) of the company's directors.

**Introduction**

This section is sometimes referred to as the recitals to the agreement. It gives a narrative of the background and purpose to the agreement. Although it is not essential, it can be a useful point to introduce unusual or complicated features of the agreement.

As a matter of general construction, this part of the agreement does not form part of its operative provisions. That is, it does not have direct legal consequences, although in cases of dispute it may be used as an interpretation guide to operative provisions which are subsequently found to be obscure, ambiguous or otherwise the subject of dispute.

It is good practice to avoid defining terms in the recitals to the agreement.

**Definitions: clause 1**

The definitions (*clause 1 of the seed investment agreement*) and rules of interpretation (*clause 2 of the seed investment agreement*) apply to the whole agreement. Great care should be taken with definitions as the construction of key parts of the agreement depends on them.

The main purpose of the definitions clause is to reduce repetition within the body of the document, making it shorter and easier to read. It also gives specific meanings to particular words used in the document. Unless expressly defined, the courts will interpret non-technical terms in accordance with their "ordinary and natural" meanings, or the meaning that it infers the parties intended by the use of the words. Extrinsic expert evidence may be required to interpret technical terms not defined in the document itself.

Whether or not a separate schedule of definitions is used, it is normal for the clause itself to appear at the beginning of the document in order to alert the reader to the conventions to be applied in the interpretation of the clauses that follow.

Defined terms generally begin with a capital letter where they appear in the body of the document. Alternatively, they may be printed in bold or in italics, underlined or placed in inverted commas (particularly in documents intended for non-business users). This highlights the fact that the term carries a particular meaning.

Words used as defined terms should reflect the sense of what they are defining. This avoids misleading the reader, and makes it easier to understand the passages in which the terms are used. This is particularly important where similar terms are being used to distinguish similar things.

***Business***

This definition is an explanation of the business carried on by the company. It is important, and links in to some of the business undertakings in clause 11 and the business plan warranty set out in schedule 5 of the seed investment agreement.

Consider the definition carefully in the context of the business undertakings and the warranties, and ensure that it accurately reflects the nature of the company's business.

***Business Plan***

The business plan is an agreed form document (*see clause 2.5 below*). It is important for the investors to have some understanding of how their investment will be used and an indication of how the company is likely to develop.

***Claim(s)***

This definition relates to claims made under the warranties.

It does not extend to other claims under the agreement or "claims" generally. The parties should review the document carefully and consider the context in which the defined term and/or the generic term appear.

***Completion and Completion Date***

In the context of an investment round, completion is the release of investment funds to the company by the investors and the issue of shares to the investors following execution of the investment agreement and verification that all necessary conditions have been fulfilled or, if capable of waiver, waived in accordance with the terms of the agreement.

The completion date is the date on which completion takes place. This will be when the conditions set out in schedule 4 of the seed investment agreement have been satisfied or waived (*see clause 4 below*).

The seed investment agreement allows a degree of flexibility with regard to completion, as no specific date is included for the completion date. In some circumstances, for example where there is only a minimum number of conditions to be satisfied, it may be appropriate to insert a specific date together with a provision allowing completion to take place on such later date as the parties may agree.

***Disclosed***

Disclosure is the process by which the company makes general and specific disclosures against the warranties contained in the investment agreement. If the company fails to disclose a relevant matter, in respect of the warranties, it may be sued by the investors for breach of warranty. The company can make its disclosures in the disclosure schedule and attach relevant documents to that schedule to support their disclosures (the disclosure bundle).

The wording of this definition is important as it qualifies what constitutes valid disclosure against the warranties in the disclosure schedule. The question of what constitutes "fairly disclosed" has been considered in a number of cases, and most recently in the case of *Infiniteland Limited and John Stewart Aviss v Artisan Contracting Ltd and Artisan (UK) PLC [2005] EWCA Civ 758*. The definition in the seed investment agreement provides that a disclosure must be fair and that is must also be full, accurate and clear, including sufficient details and explanation to clearly identify the nature, scope and full implications of the matters disclosed.

The company is usually prepared to cross-reference disclosures to the warranties to which they relate, but should avoid an absolute obligation to cross-refer every disclosure and warranty.

***Disclosure Schedule***

The disclosure schedule (including the disclosure bundle) is given by the company to the investors, and sets out qualifications to the warranties set out in schedule 5 of the seed investment agreement.

***Encumbrance***

This term can be widely construed, and may include many kinds of restriction on a person's ability to deal freely with shares or assets in their ownership or control.

Always consider the context in which the term is used, particularly where any warranties or representations are given that shares or assets are "free from encumbrances".

***Investor Director***

At completion, the investors will have the right to appoint a director to the board; the director will be referred to as the investor director (*see clause 2.3 and clause 8 below*).

***Investor Majority***

This is another of the protections that the investors will insist upon. While some matters require only the consent of the investor director, other matters will be reserved for decision by a majority of the investors themselves, some may even require the unanimous consent of all of the investors. This will be a matter for negotiation between the parties.

If the investment is not syndicated, this definition is unlikely to be necessary. In such circumstances, consider which matters require the investor's consent and which require the investor director's consent.

***Management Accounts***

This definition relates to the management accounts of the company and will be used by the investors to obtain an idea of the company's performance. Generally, all well run companies prepare un-audited, monthly management accounts.

The seed investment agreement provides for the management accounts to be in the agreed form. The investors will usually seek to have the most recent set of management accounts from the company warranted. As a general rule, these should be no more than six weeks old.

The investors are likely to seek warranties as to the accuracy of the management accounts (*see paragraph 5, schedule 5 of the seed investment agreement*).

***New Articles***

This definition refers to the new articles of association to be adopted by the company immediately before the investors subscribe for the new shares. The new articles will contain details of the rights attaching to the shares for which the investors are to subscribe (which may be preferential rights), transfer provisions and other protections for the investors. For a further commentary on the new articles of association see the seed articles of association drafting notes.

***New Shares***

This is a definition of the shares for which the investors are to subscribe, and includes details of the price to be paid for them.

***Ordinary Shares***

These are equity shares that are entitled to all income and capital after the rights of other, preferred, classes of share capital and creditors have been satisfied.

***Resolutions***

These are the shareholders' resolutions that must be passed (usually by written resolution) before completion can take place. The resolutions will include, among other things, adopting the new articles of association.

***Service Agreements***

The investors are likely to require the directors and some key employees to enter into new service agreements at completion in a form acceptable to them, although this may not be necessary for all transactions.

If the investors do not require service agreements to be executed, delete this definition and amend clause 4.2 (*requirements of completion*) appropriately.

***Shareholders***

This is a generic description relating to all those who hold shares in the company and who are a party to the investment agreement. Note that this does not refer solely to those holding shares in the company at the time that the investment agreement is executed, but also includes the investors and any other person that comes to hold shares in the company in the future and who adhere to the investment agreement pursuant to a deed of adherence (see above).

***Warranties***

The warranties form one of the investors' main protections in the agreement (*see clause 5 and schedule 5 below*).

**Interpretation: clause 2**

*Clause 2.1*

The Act contains a number of definitions that the parties may find it convenient to incorporate by reference. It is unwise to include a provision incorporating all definitions used in statutes such as this, since some of them may be wider than the parties realise.

*Clause 2.2*

Headings may be provided for clauses or paragraphs of, or schedules to, agreements in order to make them easier to locate. This clause makes it clear that the wording of such headings is not intended to limit the scope of the clauses which they identify, or to have any other effect on their interpretation.

*Clause 2.3*

This clause provides that references to an investor director should include any alternate that is appointed by the investor director to act in his place. An alternative approach would be to incorporate this wording into the definition of Investor Director itself.

*Clause 2.4*

Although section 61 of the Law of Property Act 1925 provides that "person" includes a corporation, it may be desirable to give the term a wider meaning, encompassing unincorporated bodies capable of assuming legal obligations.

*Clause 2.5*

It is often necessary to refer to ancillary documents or appendices, which do not form part of the principal agreement, but which are in a form agreed between the principal parties. These should be initialled by, or on behalf of, the relevant parties to identify them as such at completion. The seed investment agreement provides a shorthand way of describing such documents. Note, the seed investment agreement provides for agreed form documents to be agreed only by the company and the investors; consider whether the managers should also agree the form of some (or all) of these documents.

If there are a large number of agreed form documents, consider listing them in a schedule to the agreement.

*Clause 2.8*

It is a rule of construction of legal documents that, unless the contrary intention appears, where a list of matters is included in a document, the parties are to be presumed to have intended to exclude similar matters not included in the list. The purpose of the clause is to exclude that presumption, and to avoid the need to include words such as "but not limited to" or "without limitation" each time illustrative lists are used.

*Clause 2.9*

Section 61 of the Law of Property Act 1925 provides that "the masculine includes the feminine and vice versa", but does not cover references to entities whose gender is neuter, such as companies. Including this provision avoids any argument.

*Clause 2.10*

The Interpretation Act 1978 provides that where legislation is re-enacted with or without modification, then (unless the contrary intention appears) any reference in a document to the original act is to be interpreted as referring to the re-enacted provisions. A reference to legislation in an agreement will therefore be to legislation as in force at the date of the agreement. Clause 2.10 also covers previous legislation, which has been replaced or amended. This might be relevant, for example, in the case of a warranty that a company has at all times complied with the Act which is intended to catch compliance with the Companies Act 1985 or 1948 which preceded the Act. Often such interpretive points are dealt with in the re-enacted or consolidated legislation itself, but clause 2.10 puts the matter beyond doubt.

Certain alterations introduced by amending legislation may have significant, unanticipated, effects on the parties' rights and obligations. The final words of this clause are designed to prevent the parties' obligations from becoming more onerous as a result of a change in legislation but the parties may prefer to include a specific right for any party materially adversely affected by a subsequent change in legislation to terminate the agreement altogether.

**Subscriptions: clause 3**

*Clause 3.1*

This clause sets out details of the number and class of shares that the investors will subscribe for and the total subscription monies payable by them for their shares in the company.

Before any funds are made available to the company, the investors will need to be satisfied that certain matters or obligations have been fulfilled. The investors are unlikely to proceed with the investment until these matters are completed to their satisfaction (although the document does provide them with the discretion to waive the conditions). The full details of the conditions themselves are set out in schedule 4 of the seed investment agreement.

*Clause 3.2*

This clause includes an undertaking from the founders to vote in favour of the resolutions that will be put to the company's shareholders to implement the transaction. The resolutions are an agreed form document, and are likely to include such matters as adopting the new articles of association, authorising the allotment of shares to the investors and disapplying pre-emption rights (*see definition of "Resolutions", clause 1 of the seed investment agreement*). The clause also includes a waiver of any existing pre-emption rights existing under the company's existing articles of association.

**Completion: clause 4**

*Clause 4.1*

Completion of the subscription is subject to the satisfaction or waiver by the investors of the conditions set out in schedule 4 of the seed investment agreement.

In some transactions, exchange and completion may take place on the same day, particularly if it is possible for the necessary resolutions to be passed as written resolutions. However, in such circumstances, the investment agreement is still likely to contain conditions to completion, although they may be short and form a list of things that the parties would expect to be delivered in any event.

If there is to be a gap between the date when the parties enter into the investment agreement and completion, consider adding in a long stop date by which the conditions must be fulfilled and an obligation on the parties who are responsible for fulfilment of the conditions, to let the investors know of any delay or failure to satisfy the conditions.

Completion will not take place until the conditions have been satisfied or waived by the investors.

Consider whether to include a specific completion date or whether completion should take place a specified number of days after the conditions have been satisfied.

*Clause 4.2*

This clause sets out the mechanics to completion.

Consider including details of the bank account to which funds should be transferred (*clause 4.2(a)*).

**Warranties: clause 5**

The warranties are one of the investors' main forms of contractual protection. Consequently, this is a very important clause and is likely to be heavily negotiated as it provides the basis of, and remedies for, warranty claims.

Investors are likely to seek extensive warranties from the company:

* to force pre-contract disclosure about the company, on the basis of which the investors will be able to adjust their price or, in an extreme case, withdraw from the transaction; and
* to provide the investors with a basis for a claim against the warrantors for financial compensation if the warranties are breached.

The *caveat emptor* (buyer beware) principle, which underlies English contract law, applies. The investors should therefore ensure, so far as possible, that they get what they bargain for.

Consider whether it is appropriate to require the company to obtain warranty and indemnity insurance.

*Clause 5.1*

This clause seeks to ensure that the warrantors understand that the investors have been induced to enter into the agreement and to subscribe for the new shares in reliance on the warranties. In giving such an acknowledgement, the warrantors demonstrate that they understand that they will be liable (for breach of contract and potentially misrepresentation) for any inaccuracies in (amongst other things) the warranties.

Note that section 89 of the Financial Services Act 2012 provides that a person who knowingly or recklessly makes false or misleading statements or dishonestly conceals any material facts to induce (or is reckless as to whether it may induce) another to enter into an agreement in relation to shares or securities, is guilty of an offence and liable to a fine, imprisonment or both. The Managers cannot therefore wash their hands of statements made to the Investors.

*Clause 5.5*

It is common practice for certain of the warranties to be qualified by the expression "so far as the company is aware". Where this expression is used, it is likely to be acceptable to the investors only if it is qualified to mean both the actual knowledge of the company and the knowledge that it would have had, if it made reasonable enquiry of the relevant people. This means that the company does not have a get out, simply by saying that it did not know of a matter which gives rise to a claim, it also has to have asked the right people the right questions.

**Limitations on Warranty Claims: clause 6**

Typically, warrantors will seek to limit their liability in respect of a claim, at least:

* as to the amount that can be claimed (*clause 6.4*); and
* as to the period of time during which a claim can be brought (*clause 6.3*).

It may be possible to negotiate other limitations (for example, to exclude matters of which the investors have knowledge (either because they have been discovered by due diligence or disclosed), matters which are covered by insurance and to agree who shall have the conduct of claims). These will vary from transaction to transaction and will be a matter for negotiation between the parties.

*Clause 6.1*

This clause is for the investors' benefit and provides a carve-out from the limitations set out in clause 6. The limitations in clause 6 of the seed investment agreement do not apply where claims under the warranties arise as a result of the warrantors' fraud, dishonesty, wilful concealment or misrepresentation or gross negligence.

In addition, the warranty relating to the share capital of the company (*paragraph 1, schedule 5 of the seed investment agreement*) is carved out of these general limitations.

*Clause 6.3*

This clause sets out details of the time periods during which warranty claims can be made.

The time limit for bringing claims under the warranties is two years after the warranties were last given, whichever is the later. Generally, the warranties will survive for between 12 and 24 months, but the precise time period included here will be a matter for negotiation between the parties.

Also, consider whether any tax, environmental or health and safety warranties should have a longer time period in which to bring claims as it may take longer for these types of issue (such as the statutory entitlement of HM Revenue & Customs to re-open assessments for a period of up to six years after the end of a company's accounting period and soil contamination or work-related illnesses) to come to light.

*Clause 6.4*

This clause sets out the total liability for the company. Generally, the company's liability is capped at the amount of the investment, although this may, in some circumstances, be open to negotiation.

*Clause 6.4*

This clause sets out a *de minimis* limit below which warranty claims cannot be brought. Once the aggregate of all claims reaches this amount, the claims may be made, and the company is collectively liable for the entire amount of those claims rather than just the amount by which they exceed the amount set out in this clause.

Consider whether a separate (or no) *de minimis* limit should apply to claims made under the tax warranties.

**Employee share options: clause 7**

An employee share option plan (the "**Share Option Plan**") is a plan that reserves or allocates a percentage of the shares of the company for share option grants to the company's current and future employees. Share option schemes are commonly implemented following the investment in order to incentivise the company's employees and/or management by allowing them to share in the financial rewards resulting from the success of the company.

This clause may not be appropriate to all transactions. It provides that, within a specified period from completion, the company will adopt a share option plan in a form that is acceptable to the investor majority. Typically investors will require that approximately 10% of a company' share capital is reserved in a Share Option Plan. The company should then be able to issue shares under the plan without requiring further investor approval. Note that the investors will generally seek to exclude any founders and managers with substantial shareholdings in the company from participating in the Share Option Plan.

**The Board and the Investor Director: clause 8**

The objective of this clause is to ensure that the investors are kept properly informed about the company's business.

*Clause 8.1*

This clause identifies the board immediately following completion as the managers and the investor director (if appointed). The clause also requires that board meetings are held at regular intervals.

The number of board meetings and their frequency will depend on the corporate governance of each company and will be a matter for negotiation between the parties.

*Clause 8.2*

The investors will require a company to have an appropriate board of directors, including non-executive directors. It is common for the investors to seek the right to appoint a director to the board.

This clause provides that for so long as the investors hold a specified percentage of shares in the company, the investors shall have the right to appoint whomever the investor majority choose as an investor director. Consider whether some form of consultation should take place with the management team before the investor director is appointed.

Under the Act, a director is required to act in a way he considers, in good faith, would be most likely to promote the success of the Company for the benefit of its members as a whole, rather than to act as a representative of (and in the interests of) the funds that the director manages. In order to avoid conflicts of interest, venture capitalists often separate the investment decisions for the funds invested in the companies from the investor director's decisions. This is often achieved by having another investment executive representing the funds' interests when dealing with the company with respect to those matters that require investor consent (as opposed to investor director consent).

Under the Act section 175 codifies that a director must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company. This applies to conflicts arising on or after 1 October 2008.

There are two main categories of interest which an investor director may have with the potential to conflict with the interests of the company, namely: (1) his duties to the investor who nominated him (and any personal investment interest he may have in the investment); and (2) his duties to any competing portfolio/investee companies of which he is a director, in which the investor or its associates have interests.

Article 5.3 of the seed articles of association drafting notes provides a detailed analysis of the steps that could be taken by the company and an investor director to manage the potential conflicts of interest of an investor director and comply with the Act. Such steps include authorising certain interests in the articles of association, or obtaining authorisation from the board and/or shareholders. There is a limit to what the articles can authorise in terms of conflicts of interest, but it is unclear what is that limit as there is uncertainty in the interpretation of the ambit and interaction of the provisions of the Act leaving space for courts to develop the law in this area.

*Clause 8.3*

Some investors never exercise their right to appoint an investor director because of potential conflicts of interest and liability issues. In such circumstances they will often seek the right to appoint an observer to attend board meetings, but who will not participate in any board decisions. Clause 8.3 allows the investors to appoint a representative to attend board meetings. Such observer will be entitled to speak at board meetings but not to vote. These rights are commonly referred to as "observer rights".

Care should be exercised by those appointed as observers as, depending on their level of involvement in the proceedings at board meetings and the management of the company, they may be regarded as either shadow directors or de facto directors.

If any of the investors choose to appoint observers (either instead of, or in addition to investor directors), the company should consider its position regarding confidentiality carefully. The observers may be covered by a confidentiality agreement signed by the relevant investor, if they are not, consider requiring them to enter into a separate confidentiality agreement before the observer rights are exercised.

*Clause 8.6*

This clause provides that only the business set out in agendas of board meetings (which must be distributed in accordance with clause 8.5 of the agreement) should be transacted at such meetings. Other business may only be transacted if the consent of the investor director is obtained.

**Information rights: clause 9**

The company will be asked to supply regular information updates to the investors and/or the investor director. The principal purpose of this clause is to ensure that financial and other information is provided to the investors in a timely manner.

Always consider the company's stage of development when agreeing clauses such as this. For example, it may be unrealistic to ask a small spinout company to prepare audited accounts due to the time and expense required to do so.

Depending on the structure of the transaction, consider whether there should be a minimum shareholding requirement for the provision of information.

Consider whether other information such as material litigation or defaults under loan facilities should be specifically identified in the document.

**Matters requiring consent of the Investors or the Investor Director: clause 10**

The interests of the company and the investors differ with respect to whether certain acts require these additional consents. Controls such as this act as a way of reserving key decisions regarding the running of the business to the investors or their representatives (the investor director), but should enable the management to run the business on a day-to-day basis without continuous interference.

At the outset of any transaction, consider which matters are to be reserved to the investors for decision, and which are capable of decision by the investor director. The investor director's consent is likely to be slightly easier to obtain than the investors' consent (or the consent of the investor majority as the case may be) and may, therefore, be a more palatable option to the company.

An alternative approach is to require shareholders' approval for certain matters, and insert provisions in the company's articles of association. However, this is likely to be an even less palatable option for the company. Further, this may constitute "entrenchment provisions" under sections 22 – 24 of the Act.

Precisely which matters will be reserved to whom will be a matter for negotiation, and will depend on the nature of the transaction and the equity involvement of both management and the investors in the company. Generally, matters that are reserved to the investors are major decisions such as altering borrowing requirements, significant transactions and significant changes to the company's constitutional documents or business/deviations from the business plan. Less important decisions, which are generally more day to day operational matters, are often left to the investor director (*see schedule 6 of the seed investment agreement*).

**Business undertakings: clause 11**

This clause includes a number of undertakings that provide the investors with additional comfort as to the manner in which the business will be conducted. It includes provisions whereby the managers agree to promote the best interests of the company and ensure that its business is conducted in accordance with the business plan (*clause 11.1*). The company also agrees that it will apply the proceeds from the investment round in accordance with the business plan (*clause 11.2*).

**Restrictive covenants: clause 12**

Restrictive covenants are commonly entered into as part of seed fund raising. This is because, the investment is often based on the experience of the management team and the founders, and if they were to leave the company to create or work for a competitor, they could significantly affect the company's value. These provisions are often included both in the investment agreement and in the managers' service agreements.

Clause 12 of the seed investment agreement imposes a number of restrictions on the managers to the effect that they will not, while an employee or director of the company be involved in any competing business with the company, and for a specified period after the directorship or employment ceases and they will not carry on a competing business or solicit customers, suppliers or employees from the business.

Under the common law doctrine of restraint of trade, the UK courts will refuse to enforce a restrictive covenant if, the scope of the covenant goes beyond what is reasonable as regards:

* the activities which the managers are prohibited from pursuing when they leave the company;
* the geographical scope; and
* the duration of the covenant.

In view of this, the parties should seek to ensure that the restrictive covenants are reasonable. Clause 12.2 of the seed investment agreement states that the clause is seen as reasonable by the parties but if the court does not agree, this clause is also an attempt to persuade the court to delete those restrictions which are unreasonable. Note that the courts will not re-write a clause and so deletion of offending restrictions will only work if obligations are sufficiently distinct to allow parts to be separated.

**Confidentiality and Announcements: clause 13**

**Confidentiality**

The confidentiality obligations in a clause such as this are unlikely to be contentious.

The seed investment agreement includes an agreement between all parties to keep confidential all information about the company that each has obtained. This obligation includes information about intellectual property, customers, suppliers and finances. The clause specifically excludes information that:

* is in the public domain (unless such information has been wrongly disclosed);
* a party is required to disclose to regulatory authorities, for example, the Financial Conduct Authority or, if the company is listed, the stock exchange on which it is listed;
* the investor director discloses to the investor (which is covered by clause 9.5 of the seed investment agreement); and
* an investor discloses to its partners (which is covered by clause 9.6 of the seed investment agreement).

Confidentiality agreements can be difficult to enforce, they are restrictive, and will be construed against the party seeking to rely on them. The scope of the information covered and the reasonableness of the obligations are likely to be key factors in determining the enforceability of such a clause.

Always consider how the confidential information is defined.

The parties may also want to allow investors to disclose confidential information to a third party to whom they wish to sell their shares in accordance with the articles. The assistance which this may provide in attracting a buyer will need to be weighed against the risks posed by the disclosure.

Often the parties will execute a separate confidentiality agreement as soon as negotiations commence. If such an agreement exists, ensure that its provisions and the provisions of this clause are consistent. To the extent that they differ, make sure that it is clear which takes priority.

**Announcements**

Clause 13.2 of the seed investment agreement contains a prohibition on announcements unless it is a disclosure of information by the investor director to the investor or by the investor to their partners as permitted by clause 9.5 and clause 9.6 of the seed investment agreement.

Clause 13.2 also allows an announcement to be made with both board and investor majority approval. Announcements required by law, securities exchanges on which a party's shares are listed or required by any regulatory, governmental or other authority are all permitted.

Consider the sufficiency of the exceptions and whether they are appropriate in the context of the transaction. Are there additional circumstances in which the parties ought to be permitted to make announcements?

**Fees: clause 14**

This clause is drafted fairly widely, providing that the company will bear all legal, accounting and due diligence fees and expenses of the investors in relation to the investment agreement and all other documents referred to in it up to a maximum cap.

While it is common for the company to bear these costs, consider whether the costs should be limited to the "reasonable" fees referred to in the clause, or limited solely to the investors' legal fees.

**Effect of ceasing to hold shares: clause 15**

This clause makes it clear that, with effect from the date that a party ceases to be a shareholder in the company that party also ceases to be a party to this agreement.

**Entire agreement: clause 16**

The purpose of an entire agreement clause is to prevent the party relying on it from being liable for any statements or representations (including pre-contractual representations) other than those expressly set out in the agreement. The parties will normally wish to ensure that, as a matter of commercial certainty, all of their obligations are recorded in one document. The company will want to make sure that they cannot subsequently be found liable for representations that are not included in the written agreement.

There are four parts to this entire agreement clause:

* *Whole agreement*. A statement that the document concerned contains the whole agreement between the parties and supersedes any previous agreement (*clause 16.1*).
* *Non-reliance*. An acknowledgement by the parties that they have not relied on any representation which is not set out in the agreement (*clause 16.2*). This clause is designed to exclude actions for pre-contractual mis-representations.
* *Specific waiver of any rights or remedies*. Clause 16.3 goes further and constitutes a specific waiver of any rights or remedies that a party may have to claim damages or to rescind the agreement. Note, however, that it is not possible to exclude liability for pre-contractual statements that are made fraudulently.
* *Exclusion of other remedies*. An acceptance that the only remedy the parties will have are for breach of contract (*clause 16.4*). A clause such as this should always be considered alongside any provisions dealing with remedies in the agreement to avoid possible conflicts.

Note also, that to the extent an entire agreement clause constitutes an exclusion or limitation of liability, it will have to be shown to be reasonable.

**Variation: clause 17**

A variation clause is intended to ensure that a degree of formality is required for any variations to the agreement. The requirement for written variations is designed to exclude the possibility of informal, and perhaps inadvertent, oral variations. The aim of the clause is therefore to prevent disputes arising as to whether a variation has been made to the agreement; the clause requires that a variation be:

* in writing; and
* signed by the investors, the managers and the shareholders (other than the investors) who between them hold at least 90% of the company's issued share capital.

If these criteria are satisfied, the contract will be varied. However, if, as a result of a variation any new obligation would be imposed on a party or existing obligation increased, then the specific written consent of that party to the variation is also required.

**Assignment and transfer: clause 18**

This clause prohibits assignment, transfer of obligations, subcontracting, delegation or charging or dealing any of the obligations owed under the agreement without the prior written consent of the other parties.

**Rights of third parties: clause 19**

The Contracts (Rights of Third Parties) Act 1999 (the 1999 Act) gives a person, who is not a party to a contract, the statutory right to enforce a term of a contract if:

* the contract expressly provides that he may; or
* the term purports to confer a benefit on him (unless on a proper construction of the contract it appears that the parties did not intend the term to be enforceable by the third party).

Clause 19.1 is a simple exclusion of third party rights under the 1999 Act but is subject to clause 19.2, which specifically permits the general partner of the investor or the management company acting on behalf of the investor to enforce the rights and benefits of the agreement as if it were a party to the agreement.

In order that a third party may rely upon rights under a contract to enforce one of its terms, the parties to the contract should not be permitted to change that contract so as to remove that right, without the third party's consent. The 1999 Act therefore provides that, where a third party has a right to enforce a term of the contract, the parties may not, by agreement, rescind the contract, or vary it in such a way as to extinguish or alter the third party's entitlement under that right, without his consent, if his right has "crystallised" (*section 2(1), 1999 Act*). "**Crystallisation**" means that either:

* the third party has communicated his assent to the term to the contracting party who granted the right (the promisor);
* the promisor is aware that the third party has relied on the term; or
* the promisor can reasonably be expected to have foreseen that the third party would rely on the term and he has in fact relied on it.

This means that, in practice, the parties are subject to the will of the third party before they can amend or, even, terminate the contractual arrangements which they have agreed between themselves. However, the 1999 Act specifically provides that the third party's right to consent to a variation or rescission is subject to any express term of the contract (*section 2(3), 1999 Act*). For this reason, third party rights clauses often provide that no consent is required from third parties to the variation or rescission of the contract. The parties to the investment agreement might consider altering clause 19.2 along those lines.

**Conflict between agreements: clause 20**

This clause provides that, in the event of conflict between the investment agreement and the new articles of association, the investment agreement will prevail between the shareholders.

**Counterparts: clause 21**

This clause makes it clear that:

* separate copies of the agreement may be executed by only one party, or some but not all the parties, or by all the parties; and
* each copy of the agreement is an original (whether signed by one party, some but not all parties, or all the parties).

A provision such as this is useful where it is anticipated that not all the parties will sign the same copy of the agreement (although failure to include the provision will not in itself affect the question of whether or not there is a binding agreement).

**NB: Position where signatory is not physically present – the Mercury case**

To address the logistical problems in getting a document signed, it has become a reasonably common practice for signature pages to be drawn up and executed in advance, and then transferred to the engrossed final form of the document once that it is ready for completion.

This practice was considered by the High Court in R (on the Application of Mercury Tax Group Limited and another v HMRC [2008] EWHC 2721 (Admin). The judge held that the signature on an incomplete draft deed (or contract) cannot be transferred to effectively execute a complete and amended final version. The final form of deed was found not to be valid.

The Mercury decision has caused widespread concern and many people have, as a result, organised physical signing meetings to conclude a transaction that previously would have been concluded less formally. This can be expensive and time-consuming. In the light of this a joint working party of The Law Society Company Law Committee and The City of London Law Society Company Law and Financial Law Committees ("**JWP**") has prepared guidance recording a (non-exhaustive) range of options available to parties when executing documents at 'virtual' signings or closings (i.e. where some or all of the signatories are not physically present at the same meeting). This can be found by following this link:

[www.**city**solicitors.org.uk/FileServer.aspx?oID=571&lID=0](http://www.citysolicitors.org.uk/FileServer.aspx?oID=571&lID=0)*.*

The Law Society has also published a practice note to assist parties wishing to take "a cautious approach" to virtual signings in the light of the Mercury decision. It is based heavily on the guidance issued by the JWP, but includes additional guidance mainly where property documents and guarantees are concerned:

<http://www.lawsociety.org.uk/support-services/advice/practice-notes/execution-of-documents-by-virtual-means/>

The Guidance should be borne in mind when making arrangements for closings or signings, especially where some parties are looking to sign documents virtually because they are unable to attend the meeting in person.

**Notices: clause 22**

This clause governs the manner in which any notice under the agreement must be given, and the time at which such notice is deemed to be received.

Consider whether e-mail should constitute good notice, bearing in mind not only the inherent difficulties with different parties using different IT systems but also that in some jurisdictions it does not.

Consider whether any parties who reside outside the UK should appoint an agent for service of process in the UK.

**Enterprise Investment Scheme (EIS) relief: clause 23**

This clause applies when the investors are seeking EIS relief in respect their shareholding. See articles of association for A ordinary (EIS) shares. This provision stipulates that the Company and the Founder undertake to the extent reasonably practicable that they shall not contravene the EIS provisions.

**Governing law: clause 24**

The seed investment agreement provides that it is to be governed by and construed in accordance with the laws of England.

This clause enables the parties to specify the system of law that will apply to the interpretation of the agreement and its effect if a dispute arises. Parties can now also agree contractually on the law that will govern certain non-contractual obligations. This clause, therefore, includes agreement on English law as the applicable law for any non-contractual claims arising out of the subject matter of the agreement.

**Jurisdiction: clause 25**

The seed investment agreement provides that the courts of England and Wales will have exclusive jurisdiction to settle any disputes (including non-contractual disputes) arising out of or in connection with the investment agreement. Including such a clause enables the parties to agree, at the outset of their contractual relationship, which country or countries' courts are to have jurisdiction to hear disputes arising from the contract (and if desired, certain non-contractual disputes).

If there is no effective jurisdiction clause, the correct forum for the settlement of disputes will be determined by the rules of private international law (which can cause uncertainty and inconvenience).

Note that the seed investment agreement provides that the courts of England and Wales will have exclusive jurisdiction. The effect of this is that that a party is prevented from bringing proceedings against the other in the courts of any country other than these courts. Were that party to do so, the other party would be entitled to have the proceedings halted.

Consider whether the courts of England and Wales should have non-exclusive jurisdiction. This would enable the parties to bring legal proceedings either in the courts of the chosen country, or in the courts of any other country that has jurisdiction over the dispute under their own jurisdictional rules. The suing party need not first bring proceedings in the country designated as having non-exclusive jurisdiction.

**Schedule 4: Conditions to Completion**

This schedule sets out the specific conditions to completion of the subscription. They must be satisfied (or waived in accordance with clause 4 of the agreement) prior to completion.

Consider what happens if the conditions are not satisfied or waived in accordance with the terms of the seed investment agreement. For example, if the agreement is signed before the conditions have been satisfied and there is a gap between exchange and completion, consider including a longstop date. If the conditions are not satisfied or waived by this date, the agreement will terminate, usually without liability to either party, although some provisions such as those relating to confidentiality and announcements may survive such termination.

The precise conditions contained in this schedule are likely to be transaction specific.

**Schedule 5: Warranties**

Warranties are contractual statements contained in the investment agreement, and take the form of assurances from the company as to the condition of the company and its business.

The number of warranties that are given will vary from transaction to transaction. The seed investment agreement provides a basic set of warranties concerning most aspects of the company and its business and assumes it is an early stage company with limited liabilities. The warranties should always be considered both in the context of the transaction and also in terms of the type of business that the company carries out. For example, if the company does not own or develop large amounts of intellectual property, there is little point in seeking extensive intellectual property warranties.

The company will want to give as few warranties as possible. Where it is unable to give a warranty in the form drafted, they should consider:

* disclosing against it in the disclosure schedule;
* adding a materiality or knowledge qualification such as "so far as the company is aware" or "save as disclosed";
* rewording the warranty so that it is in a form that the company is able to give; or
* deleting the warranty. Note that deleting a warranty without good reason may be counter productive.

Consider any materiality qualifications such as the financial limits in the litigation warranty (*paragraph 11, schedule 5 of the seed investment agreement*) carefully in the context of each transaction. What is material for an established company is likely to be different for a recently established university spin out company.

**Warranties**

The schedule sets out the warranties to be given on completion of subscription.

A management accounts warranty (*see paragraph 5, schedule 5 of the seed investment agreement*) is important in bringing the financial position up-to-date. In relation to management accounts, a number of points need to be borne in mind:

* there is no statutory requirement for companies to produce them. What they consist of and the standards to which they are prepared are internal matters, which vary from company to company;
* they are normally unaudited and it is probably unreasonable to expect the company to warrant them to the same standard as audited accounts, although they should normally be prepared using the same accounting principles and practices.

**Schedule 6: Matters requiring consent**

The matters requiring investor consent and investor director consent are likely to vary from transaction to transaction. *See clause 10 above*.