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INVESTMENT MANAGEMENT CLIENT ALERT

UK ENTERPRISE CAPITAL FUNDS

(WITH A FOCUS ON BUSINESS ANGEL LED FUNDS)

INTRODUCTION

The UK Government has issued a consultation document regarding Enterprise Capital Funds. Essentially the concept is that the Government will make public funds available to gear up a fund established to invest in the smaller sector. The Government is looking at two types of funds:

1. the traditional fund, where the investors themselves are passive and the fund is managed by a fund manager;
2. the other is an innovative approach in that the Government are trying to find a way where they can set up a structure which is effectively managed by business angels themselves, without necessarily having an authorised person involved. This note has a focus on these business angel led funds.

The UK Government is looking to learn from the successful aspects of US Small Business Investment Companies. SBICs describe themselves as, "Public-private partnerships, contributing to an environment where America's entrepreneurs can flourish - generating millions of jobs, billions of dollars in economic prosperity, and countless improvements to our health, safety, and way of life." Whether this description is true I do not know but my US partners do tell me that SBICs are highly regarded and have made a huge contribution to the US economy. The UK Government approach is to try and take what is good about the SBIC

programme but to make (sometimes significant) changes where they think it could be improved. Whether SBICs can be successfully replicated in the UK is an interesting question as we have more of a nanny culture, less entrepreneurial freedom and good ideas are often killed in the detail of the legislation.

ENTERPRISE CAPITAL FUND STRUCTURES

HM Government are proposing two structures:

1. A limited partnership, where investors and Government become limited partners and to maintain their limited liability status the limited partners do not become involved in the management of the fund. An authorised fund manager is appointed to manage the fund. This is a traditional structure.
2. The alternative the Government is proposing is more appropriate for investors who want to be "active" in the management of their own portfolio. Again both the Government and private investors would be limited partners. However, the private investors would then form a body corporate to act as the manager of the fund. The private investors, through this body corporate, then manage their own portfolio of investments without compromising their limited liability status as partners.

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Under current legislation the body corporate acting as a general partner, managing or operating the fund would require to be authorised. However the Government are proposing that such a body corporate would not require to be authorised.

PATHFINDER ROUND OF ENTERPRISE CAPITAL FUNDS

Public money in pathfinder funds will be allocated through a competitive process. Winners will be those judged to offer the best overall value for money in achieving Government objectives (which does not mean the best financial terms to the Government).

The Government indicates it will support about 4 pathfinder funds, but the number depends on the quality of bids received. No more than £25m will be committed to a single fund.

The funds must be fixed life funds, extendable only with the consent of the Government. The shares (or partnership interests) of the fund will not be tradable on public markets. The Government will not be offering tax incentives to Enterprise Capital Funds or their investors.

GOVERNMENT CONTRIBUTION

Government will provide up to two thirds of the money in a fund with the remainder to be raised from private investors. Government funds will be released proportionately.

Net proceeds from investments of the fund are distributed:

- (a) interest to the Government at or close to 10 year gilt rate (probably about 5%);
- (b) repayment of capital to Government and to private investors;

- (c) distribution of profits to private investors, Government and if appropriate to fund managers.

Applicants have to specify terms under (b) and (c) above. The profit sharing arrangements are anticipated to be very generous to private investors. While putting in two thirds of the money, the Government will only be taking a thin slice of the profits. So assuming the fund achieves a modest level of success, the financial rewards to private investors are substantially enhanced. This is the key incentive for business angels.

APPLICATION PROCESS

Applicants have to submit a detailed business plan. Full applications have to be made within 8 weeks after the publication of finalised guidance by Government. Patricia Hewitt will judge the successful applicants following a recommendation from an independent advisory panel. Intended there will be a short list of 8-10 applicants. Successful applicants will be informed and will be then have a maximum of 6 months to secure full capital commitments and put in place the necessary legal documentation to close their funds.

STRUCTURE OF BUSINESS ANGEL LED FUND

The fund itself will be a limited partnership (LP). The Government and private investors will each contribute a nominal amount of capital to the LP in proportion to their respective shares of the profits of the fund. These capital contributions will constitute a small amount of the total commitments to the fund. The remainder of the commitments will be in the form of loans to be drawn down into the partnership as and when required.

The private investors will form a limited liability partnership (LLP as opposed to an LP) or limited company to act as the general partner of the LP and this vehicle manages the activities of the fund. This vehicle would have unlimited liability as the general partner in the LP. The private investors would have

limited liability as limited partners in the LP and as members of the LLP.

An LP and an LLP are tax transparent vehicles. On the other hand if the general partner to the LP is a limited company then there is a double whammy for CGT as a limited company is not tax transparent.

The application would have to spell out the process of decision making within the general partner. In particular there would have to be safeguards against dominant investors.

The LP would pay fees and other expenses to the general partner. The Government though would expect these fees and expenses to be substantially lower than for a fund managed by a third party FSA authorised fund manager. In addition the Government does not envisage there will be a need to be a carried interest for the general partner in the business angel managed fund.

Under current regulations the LP will itself be an unregulated collective investment scheme and the general partner as operator would need to be FSA authorised. The Government is proposing changes to the regulations to allow an angel managed fund to operate without having to be authorised, subject to:

- (a) the private investors all being certified as high net worth individuals or sophisticated investors (remember the Government are proposing to change these to self certified investors);
- (b) the private investors all being members of the LLP general partner or otherwise having the right to be actively involved in the management of the general partner; and
- (c) the private investors all signing statements about understanding risks.

INVESTMENT RESTRICTIONS

There are mandatory conditions such as:

- (a) fund not to invest more than £2m in a company;
- (b) a fund may co-invest so long as the total amount invested is not greater than £2m (excluding investors who are only providing debt finance with no equity or quasi equity elements);
- (c) within a six month period of initial investment, follow on investments only permitted if total amount invested is no more than £2m. After six months follow on investments may be permitted if either the fund's investment will not exceed £2m or an investment is necessary to prevent or reduce dilution and the total costs of the funds investment will not exceed 10% of the total fund size;
- (d) there are restrictions on the size, sector and location such as, investee company must not have its shares listed or quoted, must have fewer than 250 employees, annual turnover of less than €50m or balance sheet total of less than €43m and must not operate in certain restricted areas such as, motor vehicle, ship building, steel, coal, transport, agriculture and fisheries and the proceeds of investment shall be predominantly related to or for the benefit of the UK;
- (e) the investee company must also carry on a qualifying trade (excluded activities include, dealing in land, financial activities, property development, leasing, receiving royalties or licence fees, farming, forestry, hotels, care homes); and
- (f) structures of individual investments must have an equity component (which could include options), there must be a realistic and significant prospect of a material capital gain (not just an interest yield) and the fund is not financing the secondary purchase of existing equity (except in an MBO).

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RAISING CAPITAL FOR THE FUND

In a business angel led fund the Government require that no single investor contributes more than half of the private capital. Successful applicants in the pathfinder round will be required to achieve “first closing” with commitments of private capital to at least the level specified in their application within 6 months. The level of Government investment in the fund will be fixed at the time of first closing. If further private capital is raised between first and final closing the Government will not increase the level of its investment. The members of the general partner of the fund have to contribute at least 50% of the total investment in the fund (excluding public funds).

INVOLVEMENT WITH INVESTEE COMPANIES

A fund may appoint a director of a portfolio company. Such person may receive director’s fees. One has to be careful when being appointed as a director that the arrangements would constitute an employment relationship, that could give rise to an income tax charge under part 7 of the Income Tax (Earnings and Pensions) Act 2003.

KEY PERSONNEL

Key personnel will have to be mentioned in any application and the partnership agreement will include provisions to ensure that the key personnel named in the application actually dedicate the specified amount of time and effort to the fund. Changes in key personnel will require the consent of the Government, who will wish to be satisfied that the replacement is at least as well qualified and experienced as the individual being replaced and will integrate successfully with the rest of the team.

ASSESSMENT CRITERIA

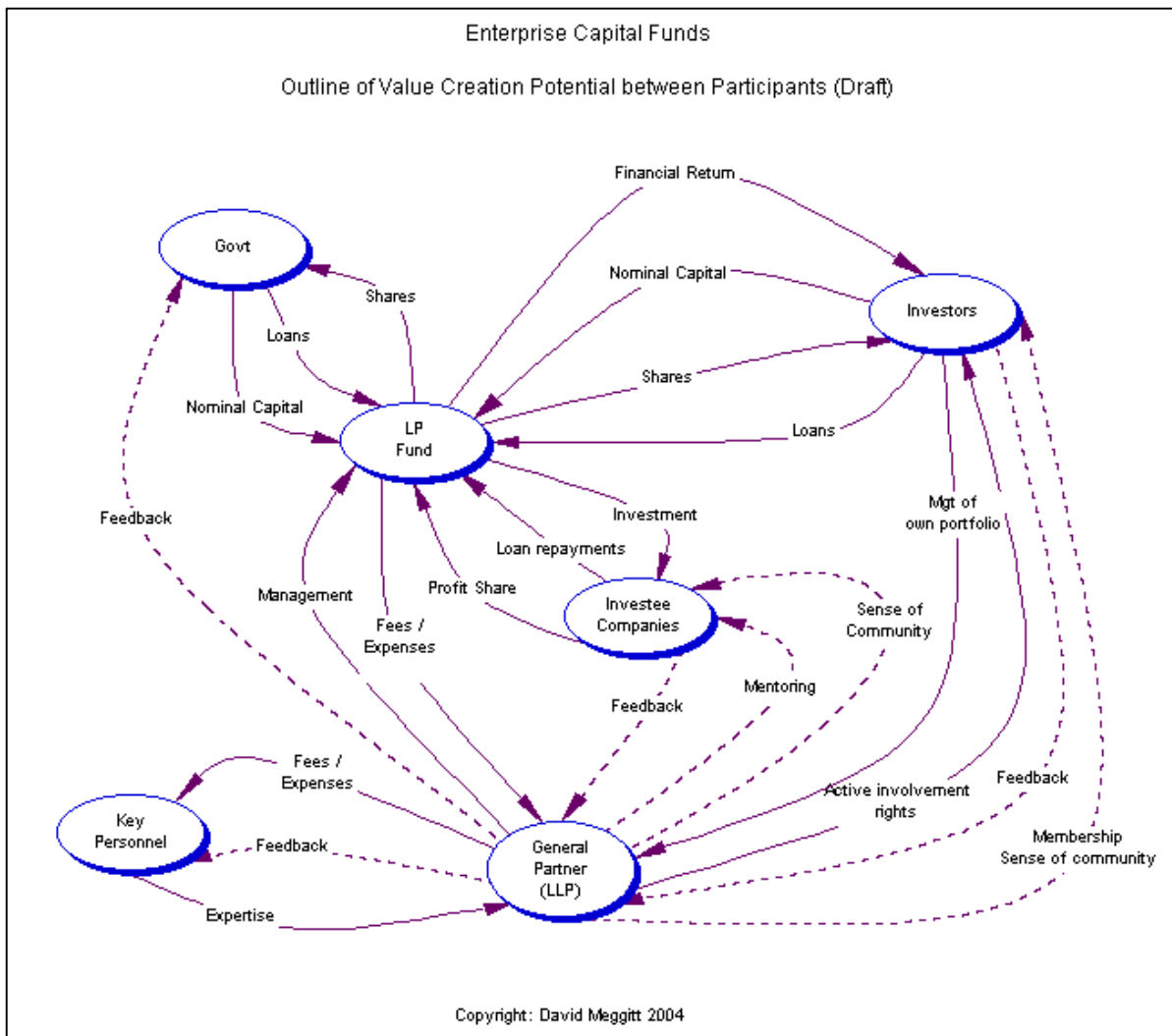
Successful applicants will be those who offer the best overall value for money in meeting the Governments objectives.

- (a) Relevant expertise and experience. Will the management team demonstrate they can – raise capital – attract a flow of quality investments – carry out rigorous due diligence – structure deals and negotiate terms – provide management support and advice to investee business (e.g. by helping to develop and implement successful growth strategies) – manage exits;
- (b) Investment strategy. Applicant must show the fund has good prospects of delivering a high financial return and that any potential conflicts of interests will be satisfactorily resolved. Also must demonstrate the fund manager will be suitable resourced – successful applications will demonstrate the fund will target a particularly acute part of the equity gap. Applicants should prepare a similar market assessment to that which a fund would require from a potential investee company. Applicant must also demonstrate non financial contribution (e.g. by providing mentoring);
- (c) Sources of private capital. Applicants must describe intended sources of private capital and specify desired ratio of Government to private capital. Successful applicants will show strong evidence of investor appetite from named and verifiable sources (e.g. written expressions of interest or conditional commitments of capital) – positive weight given to operators of the fund who invest a significant amount of their capital within the fund;
- (d) Financial terms. Sharing of loan repayments between the Government and private investors and profit sharing ratio – lower ratios of public to private capital are preferred – Government will look closely at level, structure and timing of any management fees or any other remuneration. The Government will expect remuneration to be linked to financial success.

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The following diagram, kindly prepared for this note by David Meggitt, illustrates a snap shot of current thinking for angel managed funds. It shows six participants in the ovals and the lines connecting them represent transactions between participants. Continuous lines show named deliverables that are

contracted for and which are expected. Dotted transactions represent the unexpected and where additional value can be created.



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