Venture Capital Guide 2025

Introduction

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The DWF Venture Capital Group is pleased to present our Venture Capital Guide for 2025 containing a series of thought leadership materials by over 40 of DWF's lawyers with guidance on legal aspects of UK Venture Capital transactions together with trends in the market.

The Venture Capital industry has for a long time been a catalyst for innovation and economic growth, providing crucial funding and other means of support for startups and emerging companies to grow and excel. As the landscape of Venture Capital continues to evolve, so too do the legal frameworks that govern it. This Guide aims to provide a comprehensive overview of the latest legal and market developments in the UK Venture Capital industry, offering valuable insights for investors, entrepreneurs, and legal professionals alike.

Our 2025 Guide covers the following topics:

- Key considerations in legal due diligence of Artificial Intelligence (AI) companies.
- Key pensions considerations for Venture Capital investors on legal due diligence of investee companies.
- A guide to restrictive covenants: is the business protected against a key departure?
- A guide to the different employee share schemes.
- Setting up EMI schemes is now easier for business.
- An introduction to the Enterprise Investment Scheme and Seed EIS.
- DEI in the venture capital market - challenges and opportunities.
- Drag-along and tag-along rights: what are they and key negotiation points.
- The key distinction between Private Equity and Venture Capital transactions.
- Leaver provisions: what are they and key negotiation points.
- Anti-dilution provisions: what are they and key negotiation points.
- Investment ready: preparing your business for venture capital investment.
- Convertible loan notes: conversion provisions and key negotiation points.
- Convertible loan notes: redemption provisions and key negotiation points.
- Venture capital trusts boosted by 10-year scheme extension.
- Limitations of liability in Venture Capital transactions: key provisions and negotiation points.
- Key trends in the UK Venture Capital market: resilience amidst challenges.

- Top 10 technology trends in 2025 for Venture Capital investors.

These articles cover a range of legal issues relevant to the Venture Capital industry, including contract negotiations, due diligence processes, and legal matters that commonly arise in the day-to-day operations of investee companies. Each article will provide in-depth analysis and practical insights, helping readers navigate the complexities of Venture Capital law with confidence.

One of the key areas of focus in this Guide is how to structure Venture Capital transactions. The structure of a transaction can have an impact on the rights and obligations of the parties involved, as well as the overall success of the investment. Our thought leadership materials will look at different transaction structures, including equity investments and convertible loan notes. We will also discuss the legal implications of each structure and provide practical advice on selecting the most appropriate structure for a given transaction.

Another key topic covered in this Guide is the due diligence procedure. Due diligence is a key step in many Venture Capital transactions, as it helps investors investigate the risks and opportunities connected with a potential investment. Our thought leadership materials will analyse the key legal aspects of due diligence, including the review of corporate documents, intellectual property, data protection, and regulatory compliance. We will also provide tips on conducting thorough due diligence and identifying potential red flags.

The Guide will also cover the drafting and negotiation of venture capital contracts. Negotiating and drafting contracts requires a thorough comprehension of the legal issues involved and the ability to balance the interests of all parties. Our articles will look at the essential terms and provisions of venture capital contracts, such as drag-along and tag-along, anti-dilution, leaver provisions and limitations of liability. We will also discuss common negotiation strategies and provide practical tips for drafting clear and enforceable contracts.

Whether you are a Venture Capital investor looking to stay ahead of the curve, a founder seeking to understand the legal landscape, or a professional advising clients in the Venture Capital space, this Guide is designed to be a valuable resource. By staying informed about the latest legal developments, you can make more informed decisions, mitigate risks, and seize new opportunities in the dynamic world of Venture Capital.

We hope you find this Guide informative and useful as you navigate the ever-changing legal landscape of the Venture Capital industry. If you have any questions in relation to the items covered in this Guide, then please do reach out to us.

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Key considerations in Legal Due Diligence of Artificial Intelligence companies

This article examines the key Legal Due Diligence issues to bear in mind for buyers of or investors in English companies in the fast-growing Artificial Intelligence industry.

Artificial intelligence (AI) is essentially the intelligence of machines which is different from natural human or animal intelligence. Contrary to common knowledge, it has been around for well over 50 years. Yet only in the past decade has its use become more widespread in businesses. AI mainly deals with algorithms which generally fall into one of two main types: (a) standard machine learning algorithms for example those that identify different categories that data falls under or estimate relationships between data using numbers; and (b) deep learning algorithms that learn from previous mistakes by using deep neural networks.

Given the pace at which AI has grown, most businesses and employees are unlikely to have experienced knowledge of how to work with or programme AI. Therefore, in the coming future there will be greater dependence on specialised companies in the market providing AI platform-based services and products. The trend has indeed been towards businesses using the services of these specialist AI providers rather than spending money to build their own AI platforms. This growth will boost the quality of their AI systems through more funds available for investment, especially when it comes to looking at data and learning by machines. Such growth together with new entrants into this cutting-edge market, will inevitably lead to more acquisitions and investments in the field of AI.

Corporate transactions in the AI market including M&A, IPOs and Venture Capital Investments have grown rapidly in recent years, with approximately over £25 billion of transactions occurring in 2022, an almost 500% growth from the position five years prior to that. Recent studies have shown confidence amongst companies and investors that AI will help their businesses in terms of revenues, profitability, better service, and product offerings and cutting costs. With this fast paced growth, legal systems around the world have had to adapt with newer risks and challenges associated with evolving forms of technologies. AI represents a challenge for regulatory regimes particularly as the market's risks are not fully grasped and in many cases the law is not clear. Those seeking to acquire or invest in AI businesses will need to understand the legal implications and risks associated with the use of these complex systems. This article examines such key legal issues to bear in mind for buyers of or investors in English companies in the AI industry.

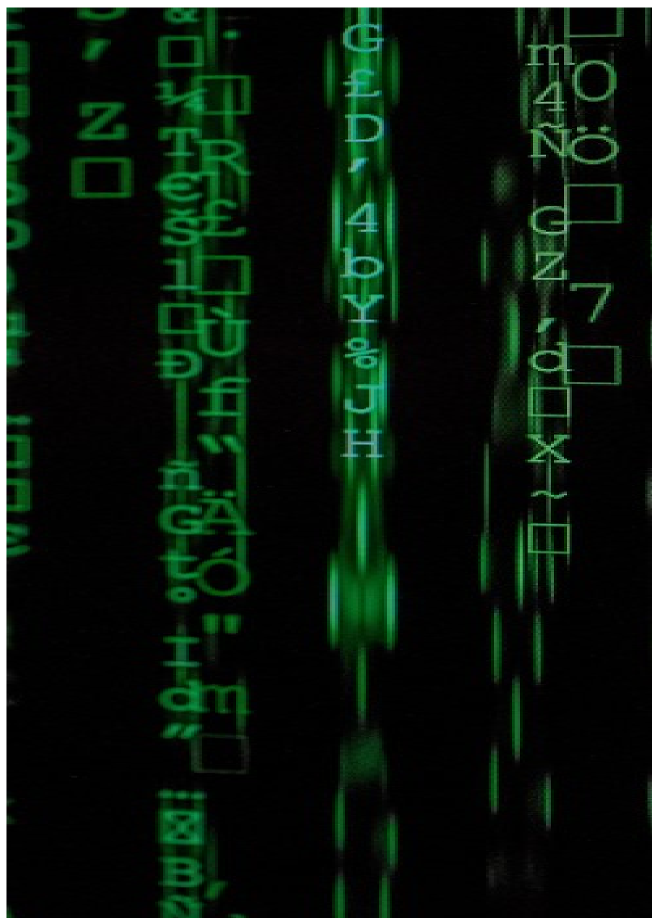
The National Security and Investment Act (NSIA)

In the UK, the National Security and Investment Act (NSIA) allows the UK government to scrutinise and intervene in certain acquisitions or investments that could harm the UK's national security. Buyers are legally required to tell the government (and seek pre-closing approval) about acquisitions of, or investments in, certain entities (known as a "mandatory notification") active in certain sensitive areas of the economy, including AI.

As AI technologies are often of general purpose and used across sectors, the NSIA captures entities that do not necessarily identify as 'AI companies.' Whether a qualifying entity is focused solely on AI or incorporates

or develops AI as part of a wider approach to their sector or business, it is the specific work that is important for the Buyer to consider.

To determine if the Target business is within the scope of the AI part of the NSIA, three questions need to be considered. Firstly, whether the Target business carries activities in the UK. Secondly whether the Target business is active in the research into, development or production of goods, software or technology that uses AI (as defined in the NSIA). Thirdly, if the qualifying entity fits this definition of AI, the Buyer needs to consider how the AI technology is being applied. In particular a mandatory notification will be required only if the AI technology does any of three things: (a) identification or tracking of object, people of events; (b) advanced robotics or (c) cyber security. It is important for potential buyers to bear in mind that Target businesses that simply make use of AI technology, as more and more businesses are doing, will not be caught by the mandatory notification regime of the NSIA. However, specialist legal advice should be sought in relation to whether a specific piece of AI falls in the scope of the NSIA.



Intellectual property

The protection of intellectual property will be of key importance in the overall value that AI businesses give to buyers and investors. In order for an AI business to use the AI system through an algorithm, it needs data which can come from various sources including the public domain, arrangements agreed with other businesses or volunteers (the AI Input). The value of the AI system lies in the final result of the algorithm processing this data (the AI Output).

The algorithms used as part of the AI business may be under trade secret protection if they are kept confidential and the Buyer should ask the Seller to confirm if this is the case and ensure that appropriate steps have been taken to preserve ownership of IP rights. The Seller should be asked to provide details of how confidential information is disclosed either by or to the Target and confirm that the Target has taken precautions to ensure trade secrets remain confidential. The Seller should provide information on whether the AI Output is owned by the Target, for example through contracts governing it or local intellectual property laws such as the protection of trade secrets. The Buyer should also ask for confirmation as to what extent the algorithm comes from third-party or open-source software. It should be identified whether any intellectual property rights and the AI systems themselves are shared with other members of the Seller's group or vice versa, and whether any such arrangements are intended to be carried on after the acquisition. The buyer should ask for details of whether the Target has faced disputes or challenges regarding the AI intellectual property it owns or uses, and these can range from issues relating to subsistence, ownership, and validity of intellectual property rights. It is also important to request information on whether any infringement by third parties of intellectual property used or owned by the Target is suspected or alleged, and also details of any suspected or alleged infringement of third party intellectual property rights by the Target.

The Buyer should find out whether any intellectual property has been registered in respect of the AI system. As to the question of patentability of AI, in the UK, the Patents Act 1977 excludes "a program for a computer" from patent protection. However, if the AI invention is considered to make a technical

contribution to the existing body of knowledge, then it may be patentable. In such a case, the legal person who made the AI has the right to be granted the patent as the inventor. Therefore, if any AI used in the business is innovative or technical then questions should be raised about the Target's approach to patent filing and sustenance and when any existing patents will expire. The Buyer should review the written terms of contracts regarding the ownership and licencing of AI inventions and patents.

The Buyer should assess whether the Target has ownership rights over intellectual property created by its employees and consultants. The UK's Copyright Designs and Patents Act 1988 expressly provides for copyright protection of computer-generated works that do not have a human creator. Where a work is generated by a computer in instances where there is no human author of the work (section 178), the author of that work is "the person by whom the arrangements necessary for the creation of the work are undertaken" (section 9(3)). It has not been confirmed by the English courts what "undertaking necessary arrangements" means, and therefore the Buyer should check for written terms of contracts regarding the ownership and licencing of AI.

The terms of agreements entered into by the Target that are relevant to the above intellectual property rights should be checked, for example licence contracts, supply and development agreements and the Target's standard proprietary information and inventions assignment agreement. The key provisions to look out for normally include the definition of AI Data and the following clauses: duration, scope, permitted use, confidentiality, AI failure, restrictive covenants, and change of control.

Data protection

The EU General Data Protection Regulation ((EU) Regulation 2016/679) (GDPR) includes within its scope personal data used in AI systems. If the Target is a data controller, then it has direct duties to data subjects but if it is a data processor then it just has duties to the controller. The Target would be a 'controller' if it, alone or jointly with others, determines the purposes and means of the processing of personal data. It would be a 'processor' if it processes personal data on behalf of the controller. It should therefore be checked which of the two categories (or both) the Target falls under. It should then be checked whether the Target processes personal data. Processing personal data at all points prior to anonymisation (or factual deletion or destruction) is within the scope of GDPR, but properly anonymised data is not within the scope of GDPR as it is no longer personal. The Buyer should examine whether the Target has been transparent in their processing of personal data in order to provide meaningful privacy notices and whether it has an adequate privacy impact assessment system.

The Buyer should check the source of the data used in the AI Input, the means in which it is used, whether the Target has the right to use the data in its AI system and whether the Target has been complying with data protection legislation in the way it uses its data. Data available generally to the public can still be protected by data protection law but the uses that can be made of it (for example altering it or interpreting it) and the underlying bases for use may be impacted by it being publicly available. For example, in a 2010 Spanish case it was held that a search engine can be a "controller" regarding the "processing" of personal data because it locates, indexes, stores, and disseminates such information. In 2022 and 2023 data protection regulators in various countries ruled that web scraping of facial images extracted from public web sources constitutes the processing of personal data. The Buyer should check that all data used by the Target is held in the Target's own systems and that the AI system has been developed in accordance with privacy-by-design principles.

Information technology

The Buyer should ask for details of the AI hardware, software, technology, and networks used by the Target. The Seller should provide verification of how reliable and functional the AI system is and confirmation that there are no regular technical issues with the AI system. The Buyer should assess how the Seller uses such AI system in its business currently and review whether this compliant with the Seller's duties of confidentiality and with applicable laws including data protection laws. The Buyer should enquire as to what types of data are used with the AI system – AI systems are only as good as the data it is trained on and there is a risk of the outputs of the AI system containing biases (which can have both legal and reputational consequences). The Seller should be asked to confirm that there are arrangements for disaster recovery, facility management, cloud computing, outsourcing, or continuing support. The fees and services levels in respect of these should also be looked at. The Buyer should assess whether shared access to the AI is needed. The Buyer should check the Target's record of cybersecurity (including details of any successful attacks on its security or integrity) and whether it has sufficient protections in place against breaches of IT security breaches including its AI system; this may include asking if there are systems, procedures and policies in operation to secure against these risks.

The Buyer should ask if any AI used by the Target is hosted by a third party application service provider or cloud service provider, whether as a platform-as-a-service, software-as-a-service, or as an infrastructure-as-a-service system, and copies of all material contracts relating to the supply, financing, maintenance and/or support of the AI system should be requested. Complete details of any open-source code used by the Seller together with copies of relevant licence agreements should be requested and analysed by the Buyer. The Buyer will be interested in finding out whether the Target has access to the source code of the key licenced AI and anything on which the source code is dependent, such as compilation scripts. It is important to check whether the Target monitors compliance with terms and conditions of its AI licences to make sure that it does not use unlicensed copies of any AI. The Seller should be asked to confirm that it does not know of any circumstances as a result of which the Target may lose the benefit of any licences. If any of the AI used by the Target is licenced to third parties, then the scope of the rights granted should be checked.

Commercial contracts

If the Target business uses smart contracts then it should be checked that any such material contracts have been validly formed under their governing jurisdiction and for this purpose the following factors will normally be relevant: capacity of each party to form the contract, the intention to create legal relations, offer, acceptance, communication of acceptance, consideration, certainty of contract and other specific legal provisions. It should be noted that under English law an AI system would not be regarded as an agent because an agent is required to be a legal person, which an AI program is not. This area of law is developing rapidly and there are moves to develop contractual terms that reflect the use of AI in the delivery of services and technology solutions.

Consents and compliance

Certain consents and licences may need to be obtained in order for the Target to operate its AI system in the countries where its business operates. The Seller should be asked whether this is the case, and it should be confirmed whether all such licences and consents are valid, subsisting, not likely to be suspended or cancelled and that there are no stringent conditions attached to any of them. The Buyer should also seek confirmation that the Target, its officers, and agents have not been on the receiving end of penalties, fines, penalties, proceedings, or other liabilities in the countries where the Target operates.

Insurance

The Target may have insurance policies in place covering risks associated with running an AI business. Copies of such policies should be requested, and it should be checked whether these policies are sufficient to cover errors, omissions, security privacy, cyber events, regulatory issues, and media risks for data breaches.

By Dhruv Chhatralia BEM with contributions from: Dimitris Sinaniotis, Asima Rana, Stewart Room, Adrian Davies, Sarah Briscall, Felicity and Jonathan Drake.

Key pensions considerations for VC investors on legal due diligence of investee companies

This article looks at key pensions risks for venture capital investors when diligencing investee companies

Due to the nature of VC investments, it has historically been common for pensions to be carved out of due diligence on investee companies. However, changes in legislation which include potential criminal sanctions have increased the risk profile associated with UK defined benefit pension schemes ("DBPS"). This seismic shift has changed the way DBPSs are being considered by mainstream lenders and in corporate VC and M&A transactions. This is something VC investors need to be aware of when diligencing new business and considering options in the event of default.

Since October 2021, the Pensions Regulator (TPR) has had significantly enhanced powers including:

- the ability to compel a scheme employer or a person associated or connected with an employer to provide financial support to a DBPS;
- criminal sanctions against any person whose acts or failures to act has a materially detrimental effect on a DBPS, where they knew or ought reasonably to have known the act would have such an effect and they have no reasonable excuse. If convicted of such an offence the penalties are up to 7 years imprisonment and/or an unlimited fine; and
- the ability to request information, inspect premises and interview under caution anyone they consider relevant to the use of their powers.

These new powers are purposefully broad and have been designed to capture anyone whose behaviours could impact a DBPS. This includes lenders and minority investors.

A particular concern for VC investors is where:

- a minority investment in a company, could result in them being "associated or connected" with a DBPS employer as a result of the investee company or another group company participating in a DBPS;
- where debt in a company with a DBPS in its group is converted to equity thereby making the VCs associated or connected with an employer of the DBPS; and
- where an enforcement event has an impact on a DBPS employer, causing the detriment to the scheme.

The above is not an exhaustive list. Ultimately, any activity which could have a negative impact on a DBPS or one of its employers could be caught. This can also include "shadow" director type behaviours. These new requirements are not designed to frustrate business as usual and should not deter VC investors from working with DBPS employers. However, it is important to diligence pensions at the outset. Where there is a DBPS in an investee company's group, consideration will need to be given to how to manage the potential risks here. This can involve contractual protections, discussions with the DBPS trustees and engagement with TPR.

By Liz Ramsaran and Dhruv Chhatralia BEM

A guide to restrictive covenants: is the business protected against a key departure?

When looking to buy or invest in a business it is crucial to consider what (if any) restrictive covenants are already in place for key employees. Restrictive covenants are designed to prevent a former employee from certain competitive activities for a period of time after their employment ends.

It is not uncommon when carrying out due diligence prior to acquisition to find the founders have no restrictions in place. Therefore, it is worth ensuring key employees sign up to restrictions prior to investing in a business. In addition, at or around the time of acquisition or investment there can be a period of staff turnover, particularly at the senior end when the future of key individuals with the business may be brought into question. The extent to which the business is protected should there be a senior departure is of paramount importance.

What are the different types of restrictive covenant?

In summary, the most common types of covenants are:

- Non-solicitation: preventing the former employee from approaching clients or prospective clients of the employer with a view to winning their business.
- Non-dealing: this covenant goes further than the non-solicitation covenant and aims to prevent the former employee from providing services to clients or prospective clients – this includes the situation when the customer or client approaches the individual.
- Non-poaching: preventing the former employee from soliciting other employees from their former employer. Non-employment covenants take this concept further and prevent the former employee from employing or facilitating the employment of their former colleagues. Anti-team move clauses seek to prevent a team move.
- Non-compete: prevents an employee joining a competitor employer or setting up a competing business for a set period.
- Garden leave: not technically a restrictive covenant, it is sending an employee home and requiring them not to carry out any business activities, for the employer or anyone else, during the notice period or part of it.

Although garden leave comes at a cost to the employer in paid salary, it is by far the most secure form of limitation on the activities of a departing employee. Garden leave is rarely challenged on legal grounds and the employee is far better controlled as they cannot

carry out any activity. Employers can avoid the argument about whether the activity is competing or not.

In addition to the above covenants employers may also seek to require their employees to notify them of offers of employment and to inform any potential future employer of the restrictions to which they are subject. Employers also rely on confidentiality provisions and fiduciary duties to limit potentially damaging activity.

Under the basic principles of contract law, it is important for the employer to give valid consideration in order for the restrictive covenants to be enforceable.

Are there limits to the post-employment restriction period and to the geographical area of the restrictive covenants?

Restrictive covenants will only be enforceable if they are no wider than is reasonably necessary to protect the employer's legitimate commercial interests. If they are too wide, they will not be enforceable. It is therefore important that restrictive covenants are focused on the potential business risk and are measured and reasonable in their extent taking account of all the circumstances.

Length and scope of restriction

With the exception of confidentiality, post-termination restrictions must be time bound. When considering what length of time would be reasonable the primary consideration is whether the duration is no longer than is necessary to protect the employer's legitimate business interests. A multitude of factors are taken into account, such as:

- How long would it take to replace the employee?
- How senior is the individual and how much exposure has the employee had to clients?
- What is the industry standard? What is the longevity of the relationships?
- What is the scope of the restriction?

Restrictions should be linked to clients, prospects, and employees with whom the employee has had material recent dealings.

The current trend is for restrictions to last for three to twelve months depending on the industry involved. It is also necessary to factor in the ability to place the individual on garden leave and ensure that the overall length of the restrictive covenant is reduced by any period spent on garden leave during the notice period.

Geographical limits

Limiting activity on a geographical basis prevents the former employee from carrying out activities in a specified area. The greater the area, the less likely that the restriction will be enforceable. With technological advances and reduced reliance on physical presence many employers work both nationally and globally, reducing the usefulness, and therefore the use, of geographical restrictions. However, where an employer is seeking to limit an employee's activities geographically, they will need to demonstrate that they have a legitimate business interest to protect and that the covenant is no wider than is reasonably necessary.

What remedies are available to the employer when an employee breaches their restrictions?

Employers often seek injunctions to restrict the former employee. Prohibitory injunctions are the most common form of injunctive relief in restrictive covenant cases. The order prevents the former employee from doing a certain activity – such as soliciting clients. Injunctions may be granted on either an interim basis or a final basis. Interim injunctions are granted on a short-term basis until the dispute can be fully considered in court, whereas injunctions granted on a final basis are considered to be permanent.

Employers also frequently request undertakings (binding promises) from the employee to refrain from breaching the contractual restrictions pending the outcome of the court proceedings.

Employers may also seek damages relating to the loss suffered by the employer in consequence of the former employee's unlawful activity.

Applications for injunctions are particularly intensive and expensive.

Interaction of restrictions in the employment contract and the share purchase agreement

The sellers of shares will often be key employees within the business. We are frequently asked whether the restrictions in an employment agreement can mirror the restrictions in a share purchase agreement or in a shareholders' agreement. The short answer to this is no (unless the restrictions in the share purchase agreement or the shareholders' agreement are relatively short in length). The reason for this is because the individual essentially has two 'hats' on – one of shareholder and one of employee. When the individual is acting in their shareholder capacity, it is seen as more of a business to business transaction, in which the buyer is protecting the goodwill of the business they have acquired often for considerable sums, and therefore an individual can be restricted for a much longer period than you would be able to restrict an employee for.

By contrast, when the individual is acting in their employee capacity, there is a perceived inequality of bargaining position and therefore you will only be able to restrict an employee for a shorter period (current trend three to twelve months depending on the circumstances as set out above). Covenants that continuing employee shareholders give in a shareholders' agreement sit in the middle ground on the sliding scale between business sellers and lowly employees: where they sit depends on issues such as the value of their shareholding and whether they are experienced senior executives or rank and file employees. So, you may want to have different classes of shares for employees in different categories, with differential covenants applying. Where you see good well drafted, enforceable restrictive covenants in the employment contract we often also see shareholders' agreement covenants being even more robust.

Another point which differs between restrictions in an employment contract and a share purchase agreement is when they 'kick in'. Restrictions in a share purchase agreement typically restrict from the point the deal completes however, restrictions in an employment contract won't kick in until the employment is terminated.

Reform

Following a government consultation it has been confirmed that a statutory cap of three months on non-compete clauses in employment contracts (but not other forms of covenant and not shareholder covenants) will be introduced "when Parliamentary time allows". It looks unlikely that this will be before the next election (not least because it was not mentioned in the King's Speech), but it is not known whether any future Labour government is also supportive. If this legislation is enacted, existing employee non-competes will need to be renegotiated.

Conclusion

A departing employee can cause significant harm to a business. Restrictions can help create stability by ensuring the business is suitably protected against such harm. Having bespoke, robustly drafted restrictions which are reviewed regularly and revisited on any promotion is crucial and should be a key requirement for anyone looking to buy or invest in a business. If an employer gets the drafting wrong the restrictive covenant can be found to be void and the employer can be left with no protection. Taking legal advice and erring on the side of caution is a sensible approach when it comes to drafting restrictions.

By Nick Dent, Charlotte Lloyd Jones and Melissa Willrich

A guide to the different employee share option schemes

What are Share Schemes?

Employee share schemes represent an increasingly significant part of a company's overall remuneration strategy. In this article our tax experts outline the different options available to employers.

Well-designed share incentive arrangements can be an important factor in attracting and retaining key personnel as well as helping to motivate staff by aligning the interests of employees with those of the company. The key to a successful scheme is careful design and implementation as well as effective communication of the scheme and its benefits.

The available options range from schemes approved by HM Revenue & Customs (HMRC), which can offer significant tax advantages to both employer and employee, to more flexible unapproved arrangements.

Share schemes are divided into two categories

Tax-advantaged share schemes

These are approved by HMRC and aim to reduce an employee's liability to income tax on the acquisition and on the subsequent disposal of the shares. In certain cases, the shares also qualify for a beneficial 10% rate of capital gains tax. Certain employee share schemes also generate a corporation tax deduction for the employer company.

The type of share schemes available to a company can be dictated by a number of factors, such as the size of the company.

The "pay-off" for the beneficial tax treatment for tax advantaged share schemes is that they have less flexibility with regards to who can participate and the terms of the schemes.

Non-tax advantaged share schemes

Under a non-tax-advantaged share option plan, employees chosen at the discretion of the company are granted an option to acquire shares at a specified future date for a price normally set at the date of grant. In tax terms, the company grants a benefit (i.e. the option) to employees and employees only pay income tax when they choose to exercise their options.

There is no statutory restriction on the level of participation for an employee in a non-tax-advantaged share option plan. However, the company is free to impose restrictions on individual participation and the overall percentage of share capital which can be placed under option to employees (shareholders may insist on such restrictions before they are prepared to accept the adoption of the plan).

Tax advantaged

There are five main tax advantaged share schemes:

Enterprise Management Incentive (EMI) Scheme

This discretionary scheme allows qualifying employees to subscribe for shares with a value of up to £250,000. There is a £3 million overall limit on the value of shares in a company that can be subject to unexercised EMI options. The scheme is generally available to UK trading companies with gross assets below £30 million and fewer than 250 full time employees.

Provided that the exercise price for the shares under option are granted at full market value the options do not usually attract any income tax or national insurance liabilities at the time of grant or upon exercise.

Company Share Option Plan ("CSOP")

This is a discretionary scheme which allows qualifying employees to receive share options up to a value of £60,000. The scheme is available more widely as the conditions are less restrictive than under an EMI scheme. Qualifying options must be granted at market value and can generally only be exercised within strict time limits to obtain any tax advantage.
Provided that the above requirements are observed, qualifying options do not generally attract any income tax or national insurance liabilities at the time of grant or upon exercise.

Share Incentive Plan ("SIP")

This all-employee share plan is operated in conjunction with an employee trust set up to 'warehouse' shares whilst they are held within the plan.

Four different types of shares can be awarded under a SIP: free shares; partnership shares; matching shares; and dividend shares. The company has discretion to award free shares worth up to £3,600 per annum to all of its employees. All employees may be offered the opportunity to purchase shares under the SIP and those that do may also be offered free 'matching' shares up to the same value.

There is generally no tax charge when shares are awarded but if the shares are removed from the plan within five years of award income tax and national insurance liabilities may arise.

Save As You Earn ("SAYE") Scheme

This is an all-employee share scheme, subject to a minimum length of service, combined with a savings arrangement under which the employee saves a fixed monthly amount usually by a deduction from salary over a three or five year period. At the end of the contract, a tax-free bonus is added to the savings to fund the purchase of share under option. Alternatively, the employee is free simply to keep the cash.

Options may be granted at a discount of up to 20% below market value and the exercise does not generally attract any income tax or national insurance liabilities provided that the options are exercised after the required option period of three or five years.

Employee Ownership Trusts ("EOT")

An EOT is a specific type of employee benefit trust ("EBT"). EOTs are established to acquire all of the shares in a company that will become employee controlled. A qualifying EOT provides:

- capital gains tax relief on the disposal of shares to an EOT;
- limited exemption from income tax on bonus payments up to £3,600 per year paid to employees; and
- relief from inheritance tax on certain transfers to and from EOTs.

There are conditions that must be met to obtain these reliefs. In brief, these are that the settled property in the EOT must be for the benefit of all of the employees; any distribution must be for the benefit of all eligible employees on the same terms; the trustees must hold more than 50% of the ordinary share capital of the company; and the company must be a trading company or the principal company of a holding group.

Non-tax advantaged

There are five main non tax advantaged share schemes:

Unapproved Share Option Scheme

Unapproved share option schemes are extremely flexible as, unlike approved schemes, they are not subject to qualifying requirements. These schemes are generally discretionary and there are no limits on the value of options which may granted to an individual employee.

Whilst options will not generally attract any tax charges at the date of grant, there are likely to be income tax and national insurance liabilities when the options are exercised.

Phantom Share Options

This is a discretionary scheme which provides employees with the right to receive a cash bonus calculated by reference to a notional share option. Effectively, the employee is entitled to receive the increase in the valuation of the company's shares without actually receiving any shares. It is not unusual for these arrangements to be subject to performance criteria and include a payment cap in case of an unexpected steep increase in share prices.
The payment made on exercise will normally be subject to both income tax and national insurance contributions.

Nil-Paid and Partly-Paid Shares

This works by the company issuing new shares to the employee in return for a subscription usually equal to market value, but with the subscription price (or part thereof) left outstanding until 'called for' by the company. These arrangements offer the advantages of immediate ownership, i.e. the growth in value being subject to capital gains tax as opposed to income tax, without any upfront payment. Payment is usually triggered by certain specified events.

Provided the subscription price is at least equal to market value there should be no income tax and national insurance liabilities when the shares are issued. Depending on the circumstances, however, there may be an ongoing income tax charge until the subscription price is paid.

Growth Shares

This discretionary arrangement involves a new class of shares being created with limited rights to income and generally no voting rights. The shares have capital rights which entitle the holder to a share in the future growth in value and to participate should a specified event occur (e.g. sale, listing or winding up). Often these rights are triggered upon satisfaction of specific performance criteria.

The shares will not generally incur any income tax and national insurance liabilities provided that the shares are initially acquired at market value. However, given the limited rights attaching to the shares, the market value is typically significantly less than the market value of an ordinary share.

Shared Ownership Plans

Shared ownership plans allow employees to acquire shares together with a co-owner, typically an EBT. This ensures that the cost of the shares is split between the two co-owners and the cost to the employee is reduced. A joint ownership agreement will govern ownership of the shares including voting rights, dividends, those circumstances in which the shares will be sold (usually a sale, listing or upon winding up) and also each co-owner's entitlement to the proceeds of sale. The employee is typically entitled to receive an amount equal to the growth in value of the shares above a fixed target growth rate.

The acquisition of the shares should not attract any income tax or national insurance liabilities provided that the employee acquires his or her interest at full market value. Given the limited nature of the employee's interest, it is anticipated that market value should be significantly lower than the market value of ordinary shares.

The use of these share schemes has declined as they have received a lot of scrutiny from HM Revenue & Customs.

By James Cashman and Caroline Colliston

Setting up EMI schemes is now easier for businesses

Changes included in the recently published Finance Act 2023 and draft Finance Bill 2024 make setting up Enterprise Management Incentives ("EMI") schemes simpler and easier for companies

An EMI scheme is one of the key incentive schemes for businesses aiming to foster growth and motivate their workforce. They offer a strategic approach to incentivising employees through share ownership. They not only help attract and retain top talent but also align the employees' interests with the company's success. By giving employees, a stake in the company's growth, EMI schemes are a win-win, driving innovation, boosting productivity, and propelling the organisation toward its goals.

The tax advantages of EMI schemes are also significant. As long as the option exercise price matches or exceeds the market value of the shares at the time of option grant:

- in most circumstances employees enjoy financial benefits with no income tax or national insurance contributions being charged on grant and exercise of their market value options unlike other non-tax advantaged incentive schemes;
- when an employee sells the EMI option shares, they'll owe capital gains tax only on the option gains (the difference between sale price and exercise price); and
- a company can often claim a deduction against corporation tax for the amount of an employee's option gains.

Recent changes to the compliance regime of an EMI scheme mean that there has never been a better time to set one up and help your company grow and your employees benefit from the rewards.

Recent changes

The recent changes are aimed at making it easier for companies to navigate compliance requirements. These changes, some of which took effect in April 2023, are expected to reduce the burden on companies and streamline processes with HMRC. Two elements of the compliance process are subject to change:

1. Notifying HMRC of the grant of the options within 92 days, and
2. Confirmation that the option holder meets the working time requirement.

Streamlining option agreement details

Starting from April 2023, companies will no longer need to provide detailed information about share restrictions within option agreements. This means that the complex task of outlining these restrictions will no longer be mandatory. Furthermore, the requirement for companies to declare that an employee has signed a working time declaration ("WTD") will also be removed. This move is intended to simplify the compliance process for companies. However, the working time requirement still applies.

Extension of notification period

From April 2024, companies will have more time to notify HMRC about the grant of an EMI option. The current 92-day period for notification will be extended, allowing companies to notify HMRC until 6 July in the following tax year. This extension aims to provide companies with a more feasible timeline for compliance and aligns with the timeline for submitting the annual Employment Related Securities return.

Reasons for the changes

These changes have a dual purpose: easing the compliance burden on companies and reducing the workload for HMRC. It is often observed that the lack of share restriction details, absence of a WTD, and failure to promptly notify HMRC within the existing timeframe are the main reasons why EMI options have failed to qualify as valid options which are tax advantaged. These issues frequently lead companies to make enquiries and requests for clarification from HMRC and their removal will ease the burden on the HMRC.

Shift in HMRC's approach

HMRC's stance on notification of share restriction details and the WTD has become more lenient over time. This change in policy reflects the acknowledgment that companies might struggle with these requirements and that HMRC has not always been consistent in responding to queries in relation to these aspects, prompting the need for a more manageable approach.

Implications for companies

The removal of these requirements is expected to significantly reduce the compliance burden on companies granting EMI options. While not mandatory, it could still be considered good practice for companies to provide option holders with a copy of the company's articles at the grant date.

Welcoming changes for companies

The adjustment in the notification period for granting options is likely to be welcomed by companies. Historically, this notification period has posed challenges for companies to provide sufficient evidence of compliance, especially during due diligence processes. Aligning this notification timeline with annual employment related securities reporting obligations could enhance overall compliance.

Taking a proactive approach

Although the new timeline allows companies more time for notification, we advise a proactive stance. We recommend registering EMI share schemes and notifying HMRC of granted options as soon as possible after the grant date. This approach ensures compliance and minimises the risk of missing notifications altogether.

Enhancing compliance and reducing pressure

These changes are anticipated to bring practical shifts in compliance requirements for companies dealing with employee share options. By streamlining processes and extending timelines, these changes make compliance more manageable for companies while also alleviating some of the pressures on HMRC.

By James Cashman, Caroline Colliston and Tom Rank

An introduction to the Enterprise Investment Scheme and Seed EIS

The EIS is designed to encourage investment in small, start-up companies. It does this by giving generous tax reliefs to investors. Obtaining these reliefs requires strict conditions to be met by both the investor and the investee company.

Tax reliefs

The EIS provides both income tax and capital gains tax relief to the investor. The investor's income tax liability for the year is reduced by 30% of the sums invested in the start-up company, up to the annual investment limit. This effectively reduces the cost of investment by 30% up to that limit (and capped at the investor's income tax liability). The current annual investment limited is £1 million, or £2 million for "knowledge-intensive companies". Knowledge-intensive companies are, broadly, companies that are carrying out a substantial amount of research and development by skilled employees.

An EIS investor who qualifies for income tax relief will also benefit from an exemption from capital gains tax on disposal of the EIS shares provided that they have owned the shares for at least three years. The investor can also defer capital gains tax arising on the disposal of a different asset by subscribing for EIS shares, provided that the subscription is made within specified periods.

Conditions

As the tax reliefs given are generous, there are numerous, complicated conditions that must be met for an investment to qualify for the EIS. Most of these conditions relate to the investee company, a key one being the "risk to capital condition". HMRC introduced this condition more recently in 2018 and it requires the investee company to be a true entrepreneurial, growing company carrying a significant risk of loss to capital for the investor. HMRC has explained that this condition is "principles-based" and has provided factors to consider in determining whether the condition is met.

The investee company must be carrying out a qualifying trade for the three-year period following the issue of the EIS shares. This condition is to ensure that the investee company is genuinely carrying on a commercial trade. Companies that carry out "asset-backed" activities, such as property development or financial activities, are excluded from the EIS.

As EIS relief is designed for investments in small, start-up companies, there are conditions that must be met relating to the size and age of the company. The value of the investee company's gross assets must not be more than £15 million before the share issue and £16 million after. The company must also have fewer than 250 employees, or fewer than 500 employees if it is knowledge intensive. The EIS shares must also be issued within seven years of the company's first commercial sale, or within ten years for knowledge-intensive companies.

An EIS investor also has to meet certain conditions to qualify for the relief. They must not be connected with the investee company for a period of two years before their investment and three years after. This means that they must not be an employee or director of the

company or already hold a material interest in the company. However, there is a tightly drawn exemption to this condition for angel investors. These are investors who become directors of the investee company at the time of their investment because they want to lend their expertise to the company. Angel investors will still qualify for EIS relief provided that the remuneration they receive for their directorship is reasonable and they were not previously connected with the company.

An EIS investor cannot qualify for relief unless their money is genuinely at risk for a period of time, generally three years. Relief previously granted can be withdrawn (essentially requiring the investor to pay back the income tax relief previously claimed) if the shares are sold within three years or other forms of value are received from the company during that period. Any attempt during that period to lock in an exit later, such as by granting of options, will also generally lead to a withdrawal of relief. One particular pitfall to avoid is that relief can be withdrawn if the company buys back shares from any investor (not just the investor in question).

Seed EIS (SEIS)

SEIS relief is a similar relief available to investors in smaller companies. The rules are based on the EIS rules; however, the investee company is limited to raising £250,000 through SEIS investment. The investor benefits from a more generous income tax relief of 50% of the amount invested, however the annual investment limit for SEIS is lower at £200,000.

It is important to note that a company cannot qualify for SEIS if it has already taken EIS investment.

Both the EIS and SEIS are highly beneficial schemes that carry generous tax reliefs, however there are many, complicated conditions that must be met to benefit from these reliefs and many ways in which these conditions can be inadvertently breached. Detailed advice is essential in order to avoid falling foul of these traps and ensure that the reliefs work in the way intended.

By Tom Rank and Zita Dempsey

DEI in the venture capital market - challenges and opportunities

The data regarding female involvement in the venture capital market makes stark reading. Women are vastly underrepresented both in terms of the demographic makeup of venture capital investors and of those companies receiving venture capital funding. The figures make for even worse reading when ethnicity is taken into account.

The Challenge

A report published by the Treasury Committee last year highlighted the issue, the British Business Bank was quoted as saying:

"For every £1 of equity investment in the UK in 2021, all-female founder teams received 2p, all-male founder teams received 84p, and mixed-gender teams 14p."

The report was critical in its assessment of the venture capital sector and also highlighted wider diversity issues within the sector, including significant underrepresentation of ethnic minorities and a disproportionate allocation of investment to London and the South-East of England.

On the other side of the coin, according to an HMRC commissioned report, venture capital investors are predominately male with 90% of investors utilising the Enterprise Investment Scheme ("EIS") being men.

These figures reflect the general picture of wealth within society. Last year, a report found that "men have on average £92,762 more in total wealth than women, a gap of 35%". The main source of wealth for men being an individual source, whereas women's wealth was found to come from property and physical possessions which are often shared and therefore is not readily available for investing.

A potential, unintentional, roadblock to the progression of women into funding circles may have been created by the proposed amendments to the financial promotions exemptions for high net worth individuals. The Treasury proposes to increase the income and net assets thresholds for individuals to benefit from the high net worth individual exemption from the financial promotions regime. This increase will disproportionately affect women by reducing the pool of female angel investors.

However, for the moment things appear to be changing, albeit slowly.

Signs of improvement?

The statistics are bleak but the picture appears to be improving with a record number of women-led businesses being set up last year. Women-led companies account for 17.3% all UK firms, up 0.5% from last year.

According to the British Business Bank's Investing in Women Code report, there is an underlying improvement in the overall picture with signatories to Investing in Women Code outperforming their peers when it comes to investing in women-led businesses. Evidently, those aware of the issue are more likely to make positive change. Highlighting the gender gap therefore will ensure that the venture capital market feels external pressure to improve its diversity.

The 'Female Foundry State of Gender Diversity in European Venture' report appears to support this view.

70% of surveyed venture capital investors are collecting data regarding the gender of their investee companies and 40% are "actively seeking more investment opportunities in female co-founded companies".

We consulted with our client, Future Planet Capital, who provided an opinion on how the challenge of underrepresentation should be met and, in particular, they outlined the need for a multifaceted approach to tackling the issue, including:

- acknowledging and supporting the development of talent at a junior level across the industry;
- the importance of social mobility programs, internships, and broader access to opportunities;
- encouraging an inclusive environment, including frameworks that encourage mentorship, provide guidance and networks, and structurally promote diversity which allows voices and unique opinions from women and ethnic groups to be heard; and
- the need for data collection and publication of diversity data to track and showcase tangible improvements and to implementing accountability across the venture capital industry at both VC level and founder level.

Opportunities:

The lack of diversity in the venture capital market presents a significant challenge to businesses led by women and ethnic groups. However, the wealth of these demographics is growing. Some have predicted that the women will hold the majority of the UK's wealth by 2025. This is driven partly by the growth in female entrepreneurship.

Caroline Colliston, tax partner at DWF, sees the challenge for these female entrepreneurs as being how to access the venture capital funding models which have been designed 'by white male accountants for white male accountants'. Pre-existing relationships significantly improve the chances of securing funding and breaking into these funding circles requires effort from those entrepreneurs seeking investment and the investors themselves to look outside their normal parameters.

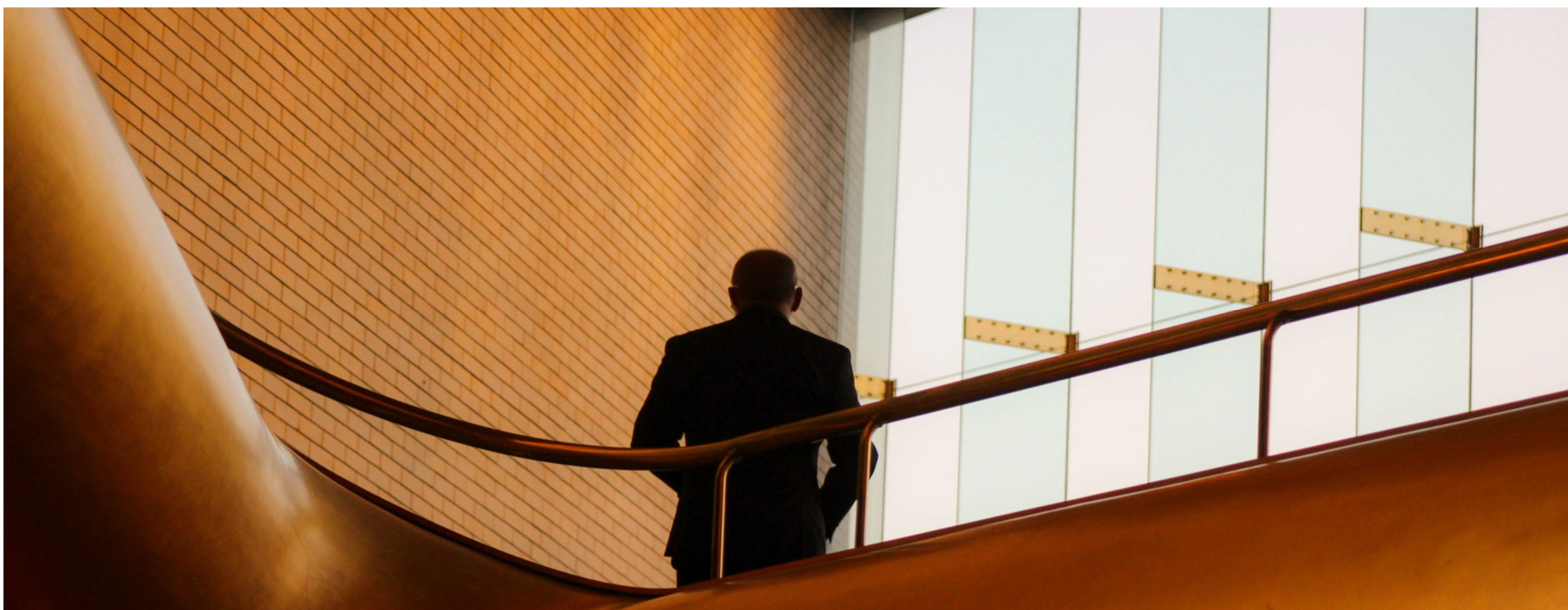
Evidence suggests that gender diversity at board level can mitigate the risk of insolvency with the insolvency rate being "49% higher for firms with only male directors than mixed boards".

There are signs of improvement and the clear need for the market to change provides an opportunity for those willing to champion the cause of greater diversity within the venture capital market. There is untapped potential that should be targeted and this starts with greater awareness of the problem and more willingness to address the imbalance.

We think the key to addressing the gender and ethnicity imbalance in venture capital funding, is to:

- raise awareness of the funding opportunities;
- address the risk appetite of female investors; and
- shine a light on the diversity issues the venture capital market faces.

By Caroline Colliston and Douglas Pyrke with contributions from Future Planet Capital



Drag-along and tag-along rights: what are they and key negotiation points

Drag along and tag along rights are common provisions typically included in the articles of association and/or shareholders' agreement of venture capital documents. They are designed to protect the interests of both the minority and majority shareholders in the event of a sale. This article will provide an explanation of such rights and the key points to consider when negotiating these provisions.

What are drag-along rights?

Drag-along rights (sometimes referred to as a 'come along' right or 'bring along' right) principally enable a majority shareholder to force the minority shareholder to also sell their shares in the company (though if a VC fund holds a minority stake in a company, it will expect to have the benefit of a drag-along right). This guarantees that the majority can deliver 100% of the share capital of a company to a bona fide third-party purchaser.

Key negotiation points for drag-along rights

When drafting and negotiating drag-along provisions, you may wish to consider the following:

- Threshold: Parties need to determine the threshold (i.e. the percentage of shares) that will trigger the drag-along right. This threshold is usually around 75% but this can be lower depending on the structure and bargaining power of the parties.
- Pre-emption rights: Pre-emption rights will usually take precedence where an agreement is silent on the interrelationship between a drag-along right and a pre-emption right. It is therefore important to ensure that this is addressed to allow the majority shareholder the ability to negotiate with the purchaser without being subject to the limitations of pre-emption rights.
- Consideration: Usually drag-along rights are drafted on the basis that the purchaser provides cash consideration. It is vital that the drag-along provision clearly sets out whether non-cash consideration is permitted as per the Cunningham v Resourceful Land Limited case.

What are tag-along rights?

Tag-along rights (sometimes referred to as a 'co-sale' right or 'piggyback' right) are provisions typically used to protect minority shareholders. In the event that the majority shareholder decides to sell its shares, tag-along rights allow the minority shareholders to participate in the sale at the same time and for the same price. These rights prevent the minority shareholders from being locked in without a viable exit.

A tag-along right provides better protection for the minority than any pre-emption rights (the right of first

refusal in favour of existing shareholders to participate in a fresh allotment or on a transfer) as it does not rely on the minority having the funds to purchase the shareholding of the majority.

In practice, it is rare to see a tag-along right exercised as the majority shareholders will secure the best price by procuring the sale of the entire issued share capital.

Key negotiation points for tag-along rights

There are a range of factors to consider when drafting and negotiating tag-along rights, such as:

- Sale of all or part shares: Consideration should be given as to whether the tag-along rights should apply to the sale of some or all of the majority shareholder's shares. A minority shareholder will want to negotiate the tag so that it applies to an agreed percentage of the majority shareholder's shares to prevent a situation where the majority can sell a significant stake (but not all) without triggering the tag-along provision.
- Notice and timing: It is important to establish procedures for providing notice to minority shareholders regarding the proposed sale and the exercise of tag-along rights. A timeline for responding to the offer and exercising tag-along rights should be clearly defined to ensure minority shareholders have sufficient time to make informed decisions.
- Execution and enforcement: Determine the mechanisms for executing tag-along rights and enforcing compliance with the negotiated terms. This may include provisions for transferring shares, co-ordinating with the majority shareholders and resolving any disputes that arise during the process.

By Darren Ormsby, Pippa James and Claudia Webb

The key distinctions between private equity and venture capital transactions:

We consider some of the key differences between private equity and venture capital transactions. The nuance is subtle yet significant, and crucial to understand.

The difference in a nutshell

Venture capital ('VC') and private equity ('PE') are similar in that both refer to equity investments in companies that are not publicly listed. However, one key difference between VC and PE is the age of the company receiving the investment. VC is typically a form of investment for early-stage, innovative businesses with strong growth potential, whereas PE investments tend to support management buyouts and buy-ins in more mature companies that have an established trading history. It follows that VC investments usually have a higher risk profile, with the target often having little (or no) track record of profitability but are in need of a cash injection to achieve the next stage of growth. In contrast, PE funds traditionally invest in more mature companies to reduce inefficiencies and drive business growth through increased margins, new sources of revenue and bolt-on acquisitions.

Key differentiators from a legal perspective

Despite the terms PE and VC often being used interchangeably, the standard terms and processes implemented in a PE transaction are not as transferrable to a VC transaction as one may think. There are key distinctions between the two and we have highlighted some notable differences below.

1. Equity and Funding Structure

VC firms normally take a minority equity stake (less than 50%), often alongside other VC firms. This equity ownership is obtained in a series of successive rounds (series A, B, C, D and so on). In contrast, PE firms usually invest in larger, more established companies and require a larger stake, often a controlling majority share (more than 75%) and buyout the entire business.

Whereas VC transactions are often structured as a direct investment into an existing corporate entity, PE deals are more typically structured as a buyout involving a number of new companies established for the purpose of the transaction. If the founder/management team holds shares in the target company, the new PE investor will invariably insist on a reinvestment of part of the proceeds of sale of their target shares – i.e. a "rollover" - to ensure that the founder/management team has sufficient skin in the game and is suitably motivated to drive the value of the newco group. As such, the management team's investment will often take the form of shares in newco subscribed for in cash, known as "sweet equity" and an exchange of some of managements' target shares for shares in newco, known as "rollover equity".

2. Leaver provisions

Across both PE and VC, leaver rights are a common feature. They ensure that if a founder or employee shareholder leaves a company prior to exit, some or all of their equity is made available to incentivise a replacement without diluting the other shareholders. The category of leaver determines what happens to the leaver's equity.

There are often multiple categories of leaver in a PE transaction, whereas VC deals normally only cover

'good leaver' and 'bad leaver'. In a PE deal these will typically look something like:

- "Good leaver" – an employee who leaves in circumstances where they are generally not culpable, for example, death, incapacity, or wrongful termination; and
- "Bad leaver" – an employee who leaves in circumstances where they have done something wrong such as gross misconduct, criminal offences, or other summary dismissal.

However, in VC deals it is more common for 'bad leaver' to cover scenarios such as voluntary resignation and breach of any restrictive covenants, with founders arguing that 'good leaver' should be more broadly defined as all other scenarios. This is more beneficial than PE transactions where the definition of 'good leaver' is intentionally very narrow to ensure that management are committed to the target business for the full life cycle of the investment.

In PE deals, the categorisation of a person as either a good leaver or a bad leaver will usually determine the price at which they are required to sell some or all of their shares in the company on departure. However, in VC deals it is common for a proportion of a good leaver's shares and all of a bad leaver's shares to automatically convert into deferred shares, avoiding pre-emption implications that are common in PE transactions.

On a PE transaction, a leaver's "sweet equity" and "rollover equity" will generally receive different treatment as management will argue that their reinvestment is value they have already created and so should be protected from any leaver arrangements.

3. Vesting

In light of more beneficial leaver provisions, a key feature in VC transactions is the vesting schedule linked to the leaver provisions. Commonly, the vesting schedule allows a founder to 'earn back' their equity over time where they are deemed to be a good leaver.

Vesting will usually occur on a 'cliff' basis meaning that a defined percentage vests straight away or on an anniversary of the investment, after such time the vesting will occur monthly or quarterly (usually across a period of 4 years). Vesting may also be aligned with performance or upon hitting certain milestones and can be accelerated on the occurrence of certain specified events, such as the sale of the company or if the founder is wrongfully terminated without cause.

In contrast to VC transactions, vesting in PE deals is typically only relevant where the concept of 'intermediate leaver' is introduced (and consequently the circumstances in which a manager is considered a bad leaver scaled back from catching any leaver not considered a good leaver) to capture the circumstances in which a manager is neither a good leaver or bad leaver, but who leaves within a specified period after completion of the buyout.

4. Ratchets

A ratchet is a common feature of PE deals. It is a mechanism which increases the amount of equity held by managers if certain performance targets are reached and therefore allows the management team to get a larger slice of the proceeds on exit if the target business exceeds its projected performance.

Contrastingly, in VC deals, a ratchet is used to implement anti-dilution rights to protect an investor against a decrease in the valuation of the company following the VC's investment. Early-stage companies often go through numerous rounds of VC investment.

During this process, the company may find that their valuation has dropped in between rounds (commonly referred to as a 'down round'). An anti-dilution ratchet aims to protect a VC investor by entitling them to extra shares (at no or minimal cost) to ensure that the average price per share paid by the investor is adjusted to avoid the investor having overpaid in the previous round of investment.

5. Drag along

A drag-along provision enables a majority shareholder who wishes to sell their shares to force the minority shareholders to sell their shares too. It is a common investor protection in both VC and PE deals as investors know that any potential buyer is unlikely to be willing to buy anything less than 100% of the target.

Most PE investors require an unfettered right to exercise a drag along. However, on VC transactions the drag right is typically only exercisable by the majority shareholders acting together, including the investor majority. This importantly gives an investor the right to exercise a drag right but also the ability to block another shareholder from invoking a drag right. This avoids a situation whereby an investor can be dragged into an exit that it does not approve.

By Will Munday and Faith Baker

Leaver provisions: what are they and what are the key negotiation points

Founders and senior management are usually central to the decision of venture capital investors' decision to invest in a company; they are key to the success of any investment. Therefore, an investor wants to ensure that management are committed to the company for a set period before they can realise any meaningful return on their investment.

Leaver provisions are an essential provision within a company's articles of association through which this can be achieved. On the other hand, these provisions are the most sensitive area for management who want to protect their financial returns, and importantly, recover the value they have created in the business.

What are the key negotiation points when agreeing leaver provisions?

It is crucial to note there is no mandatory market standard that is required to be followed when negotiating the leaver provisions. This means defining what constitutes a "good leaver" or a "bad leaver" and determining the subsequent handling of their shares following their exit is a matter of negotiation between the parties. Key points to consider during negotiations are:

Types of Leavers

It is common for a company's articles of association to only define a "bad leaver" and a "good leaver". However, it is important to note that "very bad leaver" or "intermediate leaver" definitions can also be included. The end result comes down to the negotiating position of the parties involved. Determining the price a leaver is entitled to for their shares will depend on the category they fall in to.

- Bad Leaver / Very Bad Leaver: management will want to ensure that the circumstances in which they could fall into these categories are entirely within their control – e.g. voluntary resignation (within a certain period of time of the initial investment), termination for gross misconduct or dishonesty or committing a breach of any non-compete obligations under the shareholders' agreement. The price payable for the shares in these circumstances would usually be the issue price or £1 in aggregate.

- Good Leaver: a good leaver would receive market value for their shares at the point at which they become a leaver and therefore ordinarily these would apply in circumstances such as permanent ill health, death, retirement, wrongful dismissal.

- Intermediate Leaver: an intermediate leaver may be used to cover any other circumstances in which a person becomes a leaver that do not fit into either the good or bad/very leaver categories. The price payable would ordinarily be determined by reference to a vesting schedule to reflect the value that the shareholder had contributed to the company during the period in which they held their shares.

Handling Leavers Shares

Once the status of the leaver has been confirmed, the next step will be to deal with their shares.

The investor will want to ensure that such shares can be warehoused to be used to incentivise future joiners, and this can be achieved by either (a) a transfer to the investor or an employee benefit trust or (b) a company buy back and cancellation of the shares. The investor may also want to be able to cap the leaver's shares at the price determined (as set out above) in the event they are unable to acquire them from the leaver on or around the date in which they become a leaver. The result of this would be that the leaver would keep their shares, but they would no longer be entitled to vote or receive dividends on such shares and the price payable to them on a future sale of the company would be capped at the leaver sale price. Management would be reluctant to agree to defer receiving value on their shares in this way.

Management will want to ensure that the leaver shares are ring-fenced for management and would therefore seek to negotiate that either (a) such shares are transferred to existing members of management pro-rata to their existing entitlement or (b) the shares are transferred to an employee benefit trust or bought back by the Company, in each case, on the proviso that such shares are allocated to future members of the management team.

Leaver provisions are complex and require meticulous drafting to ensure fairness and protection for both the investor and the Founders / management team. Having adequate leaver provisions within the articles of association of an investment company will promote the company's success; by ensuring the key members of the company who are vital to the company's growth are deterred from leaving the company.

By Will Munday, Rosie Spencer and Marta Borowicz

Anti-dilution provisions: what are they and what are the key negotiation points

If a company issues new equity securities whether directly by a new issue of shares or indirectly through the issue of options or other convertible securities, all existing shareholders or investors may suffer a dilution of their shareholding and thus their proportionate ownership of that company.

Accordingly, venture capital investors who are minority shareholders and unable by themselves to vote down any shareholder resolutions which may be proposed authorising the board to issue new equity securities, often require anti-dilution mechanisms to be adopted which protect their investment from dilution in the event of any future fundraisings.

Although an outright veto on any new equity securities being issued by the company is the most effective type of anti-dilution provision since it gives an investor total control of whether the company can issue any new equity securities, it is relatively rare since the company and the other shareholders will usually insist that the company should be able to issue additional equity securities should the company require new finance in the future and debt finance is not available.

Price based anti-dilution provisions

Price based anti-dilution provisions are used by investors who wish to protect themselves against a company issuing additional shares at a share price which is lower than the share price which they paid. This is a real risk for investors especially in early stage companies where valuations may have been stretched or the company is pre-revenue.

This type of funding round is commonly known as a 'down round' and they are particularly unwelcome for investors as the lower down round share price magnifies the dilutive effect of the new equity securities being issued.

To counter the effects of a down round, investors have developed anti-dilution provisions called 'ratchets' which enable the investor to receive additional shares for nil or very little further payment by adjusting the price they originally paid for their shares.

Different types of 'ratchets' are used by investors, and these can have different consequences for the other shareholders. There are two main types of ratchets:

- Full ratchet – where the investor's original investment is re-priced at the share price of the down round and the investor receives a bonus issue of new shares to increase its shareholding to what it would have received had its original investment been made at the down round price. This is the strongest type of anti-dilution ratchet protection for an investor but full ratchet protections are usually resisted by investee companies and other shareholders since it can make the company less attractive to future investors and can also lead to additional dilution for shareholders who do not also benefit from such provisions (e.g. employee and management shareholders).

- Weighted average ratchet – this is the more common form of ratchet used by investors and it seeks to take into account the extent of the investee company's issued share capital when re-pricing the investor's investment price, the theory being that it is unfair to completely re-price all of an investor's original investment in respect of a down round which might be relatively small in comparison to the overall issued share capital of the company. To put it another way, the weighted average ratchet seeks to better measure what the extent of the increase to the issued share capital of the company is as a result of the down round.

Weighted average ratchets can either be broad based or narrow based. A narrow based ratchet will take into account only the actual issued share capital of the company but a broad based ratchet will also take into account any unexercised share options, convertible securities, warrants and so on.

A broad based ratchet will be of most benefit to other shareholders since it increases the potential size of the company's share capital against which any ratchet is to be calculated.

Other key negotiation points

In addition to negotiating the types of anti-dilution protections which might be employed, other potential areas for negotiation include:

- Pay-to play: these provisions provide that if an investor does not participate at all or fails to take up a pre-defined minimum percentage of new shares (by reference to their entitlement under the pre-emption provisions) under any down round, they may lose some or all of their anti-dilution protection. These are generally used to incentivise investors to participate in future fundraisings (including any down rounds) and are a useful tool to ensure that the investors continue to reinvest in the company. Pay to play provisions can also be drafted so that they:
    - reward investors who exercise pre-emption rights by exchanging their existing shares with either

        (a) a similar class of shares having better economic rights; or

        (b) a new class of shares with better rights attached to them; or
    - punish investors who fail to exercise their pre-emption rights in a new round of fundraising by either

        (a) forfeiting their price-based anti-dilution protection or

        (b) converting their existing shares to a new class with fewer rights attached.
- Ownership threshold: a company can seek to restrict granting anti-dilution protection rights to investors whose equity ownership exceeds a minimum threshold. If the categories of investors benefitting from such protections are too large, this can become administratively cumbersome for the company and may limit the company's ability to undertake further fundraising rounds.
- Exceptions to price-based anti-dilution protections: it is usual to exclude certain types of new equity securities issues from the price-based anti-dilution provisions and such exceptions will vary from transaction to transaction but commonly these include new issues of equity securities:
    - to existing investors on any conversion of their pre-existing options, warrants or other convertible securities; and
    - after the date of the relevant investment round, to directors, officers, employees, or consultants of the investee company pursuant to exercise of any stock options or other incentive equity.

Generally, anti-dilution provisions are tailored and adopted depending on the nature and scale of the investment and as ever the respective bargaining position of the parties involved.

By Scott Kennedy and Adil Jahanghir

Investment ready: preparing your business for venture capital investment

With the new government making it abundantly clear that it sees increased private sector investment as the cornerstone on which the UK can build a sustained period of growth, DWF anticipate that increased venture and growth capital will be a fundamental aspect of that economic strategy.

The hope is then that with the support of its new administration, the UK can enhance further its position as the top destination for venture capital investment in Europe. This article looks at five key things for any company seeking venture capital funding to consider prior to entering into negotiations to ensure that they are "investor ready".

Intellectual Property

For technology companies in particular, intellectual property, and particularly the protection of that intellectual property, is essential. Protection of the intellectual property can be in the form of registration of a trademark or a patent or in something less tangible such as copyright. One of the most basic forms of protection, but one that is regularly missed by early stage companies, is for written contracts with developers and employees to state properly and comprehensively that any intellectual property developed by the developer or employee in the course of that engagement will be the property of the company and not that of the individual. Where the contracts fail to detail to whom the intellectual property belongs, there may be a presumption that it belongs to the individual and not the company – this is something that can be difficult to remedy and is not an easy one on which even the most seasoned investor can take a commercial view and move on.

Corporate Structure

For many investors, investing in a company with a clean share capital structure and history will be one of the "absolutes" on a venture capital transaction. Investors want to know the exact proportion of the pie that they are receiving. Unfortunately, with surprising regularity, when DWF are carrying out corporate legal due diligence on venture capital transactions, we uncover historic issues where errors have been made that mean that the share capital structure is not as the company, or the founders, anticipated it to be. The most common issues are as a result of flawed share buybacks, but even more basic errors simply demonstrate a lethargy and lack of attention on the company's part as regards critical admin/housekeeping. Where problems are identified with a company's share capital, those issues are often challenging, time consuming and (potentially) expensive to remedy, all at a time when money is ready to be invested.

People

It is the most obvious point but having the right people in place is crucial in any business and all companies are seeking that perfect blend of technical understanding and business acumen. Investors are attracted to individuals they trust to enhance the value of their investment and use that investment wisely. Trust is key: never attempt to hold something back from an investor. What a company thinks might scare off an investor rarely does so. Most issues are surmountable. Early stage companies will ideally have key personnel to build or develop a product and those able to commercialise the product. Most investors do not have the time or the desire to run a company day-to-day.

They want the management team to operate the company for them and, as a result, they are attracted to individuals they trust to enhance the value of their investment and use that investment wisely. Therefore, senior management in an early stage company may have to make tough decisions at an early stage on who the best people are to make the company a commercial success story.

Contracts

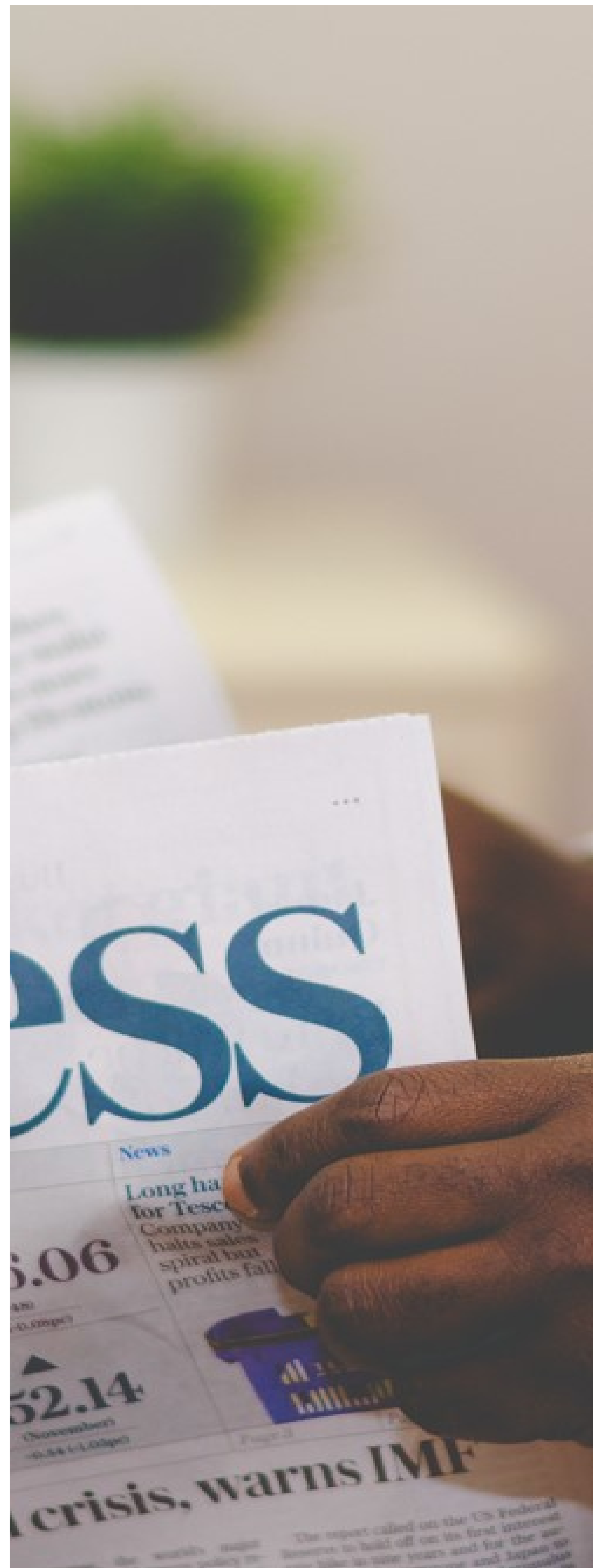
All contracts, from employment contracts to leases of office space and standard terms and conditions, should be formalised in writing. Again, it is a sign of professionalism and attention to the basics. Investors will have an expectation that all key contracts are in writing prior to handing over any funding. Where this is not the case, the associated risks can be enough for an investor to walk away or, at the very least, negotiate a reduction in the share price because of the unnecessary additional risk.

Tax

Where investment is predicated on an investor receiving certain tax reliefs (most commonly in venture capital transactions, EIS relief) the company should do everything in its power to have all necessary approvals and assurances in place with HMRC at as early a stage as possible. Companies can make sure they are ahead of the game by speaking to advisors at an early stage and putting the wheels in motion with HMRC. Failure to have the necessary approvals could result in a lengthy delay whilst applications make their way through the machinery of HMRC and may delay any potential transaction: and delays can be dangerous when there is an appetite and momentum to invest.

While there are significantly more issues of interest to an investor, a lot of which are bespoke to the business in question, we have used this article to highlight some of the simple ways that companies can "get their house in order" to ensure that they are ready and prepared to take on that venture capital investment that will propel them to the next level in their growth story.

By Paul Pignatelli and Graham Tait



Convertible loan notes: conversion provisions and key negotiation points

Convertible loan notes can be attractive for early stage, high growth businesses looking to raise capital. In this article, we set out some of the advantages, key legal terms, and negotiation points to be aware of.

Why use convertible debt?

A convertible funding round is generally a more efficient process than traditional equity or debt fundraisings, with convertible loan notes typically being priced more competitively than long-term institutional debt and being subject to fewer conditions.

Crucially in an early-stage business they allow for the valuation to be determined at a future point in time, upon conversion of the notes. Where the business is at a pre-revenue or development stage this can be useful in giving both investors and founders comfort that the business will have time to develop and demonstrate its model.

In addition, convertible notes are non-dilutive to shareholders at the point of issue. However, the conversion metrics are key, and all shareholders should be aware of the potentially dilutive effect.

Conversion mechanisms

Central to the function of convertible notes are the provisions by which the loan is converted into equity. Conversion is usually triggered automatically on the occurrence of a further funding round or an exit event. Usually (although not always) the notes convert into the class of equity that other investors are allotted at that time. However, the notes may also include a discretionary conversion right, afforded to the investor or the company if sufficient time passes without a conversion event; or may convert into a subordinate class of equity to a new senior investor.

The negotiation of these conversion provisions represents the fusion of various factors: what stage is the company at? What is the capital required for? Is a future funding round proposed? What are the timelines to achieve these milestones?

Agreeing an instrument which satisfies both parties may present challenges. The duality of being able to elect creditor or shareholder status is desirable to an investor. However, founders will desire control over their balance sheet and the ability to manage dilution by triggering conversion rights at a point of their choosing.

Ultimately, the agreed terms will be a product of the business's strength, the underlying commercial rationale for the note issuance, and pricing.

How to approach conversion pricing

The price per share at which the debt will convert into equity (the conversion price) is the key commercial term of the notes.

Typically, the conversion price is set by reference to the next issue of shares, on the basis that an incoming investor will determine the market value of the business at that time.

Market practice is to apply a discount to that price for the noteholders, in recognition of the risk taken by investing through the convertible round. A discount of 10% - 20% of the subscription price paid by other

subscribers is not uncommon, although this is variable, with a lower discount applying if the company achieves a higher valuation ("descending ratchet").

The discount rate, along with discretionary powers and the conversion class of equity, are all tools for negotiation. Investors may, for example, be prepared to waive discretionary privilege in favour of a greater discount, or vice versa.

Other key terms

While generally regarded as a 'light touch' instrument as regards investor protections, noteholders may require certain information rights during the life of the notes, for example monthly management accounts, and updates on material matters.

Due diligence is likely to also be light touch, however an investor may wish to see key legal, IP, regulatory or commercial documents to support the business case. Founders should also be aware that any information provided to an investor during the process could be deemed an inducement to invest that the investor has relied upon, and therefore should seek to ensure the accuracy of any factual information, and that any opinions or forecasts are prudent and can be supported by evidence.

Founders may also be asked to give warranties regarding such matters as the accuracy of the information provided and the legal status of the business. It is advisable to seek advice regarding warranties, as these can attract personal liability for founders, which can be mitigated by a formal disclosure process.

In summary

Convertible loan notes are a commonly used and very useful instrument for early stage and high growth businesses looking to raise short-term development capital quickly. They allow flexibility and the headroom to begin scaling a business - although they are rarely a long term funding solution and are usually a stepping-stone to a more substantive balance sheet event.

As well as the financial benefits of increased liquidity, they also allow businesses to build relationships with investors, giving them a 'seat at the table' on their growth journey, and access to investors' expertise as an experienced partner.

Commercial terms can vary greatly and will be a product of the strength of the business and the investor's appetite for risk. Choosing the right partner, being open and transparent with investors, and maximising the company's strengths are key to a successful negotiation.

By James Bryce, Narissa Pankhania, Matthew Kernohan and Lily Maffei

Convertible loan notes: redemption provisions and key negotiation points

This article explores convertible loan notes, redemption provisions and negotiation points to achieve a mutually beneficial agreement.

The factors to consider when negotiating such provisions are explored in detail below.

Redemption provisions

Trigger events are paramount to providing investors with security and ensuing them with the comfort of being able to exit their investment under carefully defined circumstances. Such trigger events commonly negotiated include the maturity date of the note without a conversion event occurring; where there is a significant change in control of the company; or a failure by the company to meet revenue, growth targets or other financial metrics.

Redemption provisions provide investors with a safety net for their investments. However, these provisions could be a double-edged sword for companies: while CLNs make it easier to secure investor funding by making investments more attractive, redemption provisions could also create cash flow obligations for companies, impacting their financial planning and requiring careful management.

Negotiation points

Regarding trigger events, investors could seek clear and specific trigger events that allow them to redeem their investment. They may also strive to negotiate broader redemption triggers to provide greater security. Conversely, the company may pursue a narrower list of trigger events to maintain flexibility and manage their financial growth.

Redemption premiums are beneficial for investors investing in start-ups with high-risk profiles, as the company would have to repay the loan along with a pre-agreed redemption premium. In contrast, the company would endeavour to eliminate or minimise redemption premiums to retain capital and control over their equity structure. Striking a balance is paramount in maintaining both security for investors and financial continuity and stability for the company.

Timing and notice periods are key points to consider when negotiating such provisions. The company may reasonably negotiate longer notice periods before any redemption rights can be exercised by investors, ensuring that they have adequate time to grow and manage cash flow. Conversely, investors may seek shorter notice periods to allow for a quick exit.

Investors may also seek further flexibility in redemption by negotiating a partial rather than a full redemption. This provides investors with the security of redeeming a portion of their investment whilst keeping the remainder in the company. Companies also need to consider how redemption provisions affect future financing rounds, particularly in terms of debt seniority and subordination.

Conclusion

In summary, redemption provisions offer a mechanism for investors to mitigate risk while providing companies with the flexibility to raise capital without immediate equity dilution. Therefore, it is vital to strike a balance that protects both parties' interests and secures a mutually beneficial agreement.

By Amrish Sharma, Jagdeep Lall, Andrea Tarazi and Ceren Ghanem

Venture Capital Trusts Boosted by 10-Year Scheme Extension

The 10 year extension of the Venture Capital Trust (VCT) legislation ensures a secure future for VCTs as an investment vehicle providing tax efficient investment opportunities for retail investors, and (for qualifying companies) access to a pool of long term growth capital.

This article outlines the basics of how VCTs are structured, the tax reliefs available to investors in VCTs and what to look for if you are a company considering whether you qualify for investment from a VCT

VCTs

Established by the UK government in 1995, VCTs are an investment vehicle that allow retail investors access to investment in smaller, high-growth businesses while benefiting from significant tax reliefs.

VCTs are publicly traded companies on the London Stock Exchange, structured to collect funds from investors buying shares in the VCT. These funds are then invested in qualifying, unlisted companies, providing capital for growth and development. A type of investment trust, VCTs are managed by professional fund managers, who select and manage a varied portfolio of investments, focussed on high-growth, innovative sectors.

Through investing in a VCT, individuals have exposure to a range of smaller, unquoted businesses that may otherwise be beyond their reach. The UK Government's recent 10 year extension of the VCT legislation strengthens the entrepreneurial ecosystem by promoting economic growth and innovation, while incentivising investors with significant tax benefits.

Tax benefits of VCTs

VCTs offer investors a variety of potential tax benefits to qualifying investors:

Income Tax Relief: Individuals can claim up to 30% income tax relief on investments of up to £200,000 per tax year, provided the shares are held for at least five years. The tax relief scheme offers significant savings, encouraging long-term investments and supporting SMEs. However, investors must be comfortable that they will need to hold the VCT shares for at least 5 years and also ensure they are fully eligible and compliant with legislation, as this relief is subject to restrictions.

Tax-Free Dividends: Dividends received from VCTs are exempt from income tax, making them an attractive source of tax-free income. However, investors should consider the risks associated with VCTs, such as potential capital loss and the limited liquidity of VCT shares (particularly with the 5 year holding requirement for income tax relief). Funds will have different investment policies and track records, and a proper understanding of each VCT's risk profile is crucial.

Capital Gains Tax (CGT) Exemption: Any gains made on the disposal of VCT shares are free from CGT, provided the shares were acquired within the annual investment limit. However, investors must be mindful that VCT investments do not guarantee gains in value, so this exemption does not guarantee profits.

These tax incentives are designed to offset the higher risks associated with investing in early-stage companies and encourage long term capital investment. This makes VCTs a potentially appealing option for investors looking to diversify their portfolios and support the growth of smaller UK businesses.

Qualifying conditions for VCT

A VCT is permitted to invest in specific, qualifying companies. The list of rules around qualifying investee companies is non-exhaustive, but some key considerations include:

- Unquoted: The company must not be quoted, although its shares may be traded on the Alternative Investment Market (AIM).
- Employee Limit: The company generally must have fewer than 250 full-time employees, although if the investee company is a parent company, then the number of employees of each qualifying subsidiary of the parent must be within the limit. The limit also depends on whether the company is 'knowledge intensive', where the limit is 500 full-time employees.
- Gross Assets: The company's gross assets must not exceed £15 million before investment from a VCT and no more than £16 million immediately afterwards.
- Trading Activity: The company must be engaged in a qualifying trade, which includes a wide range of activities, with several exceptions, including:
  - Dealing in land, shares or commodities;
  - Financial activities;
  - Property Development; and
  - Farming.
- Age of Company: The company must receive its first risk finance investment within 7 years of its first commercial sale, or within 10 years for a 'knowledge intensive' company. The definition of a first commercial sale excludes limited sales to test the market.

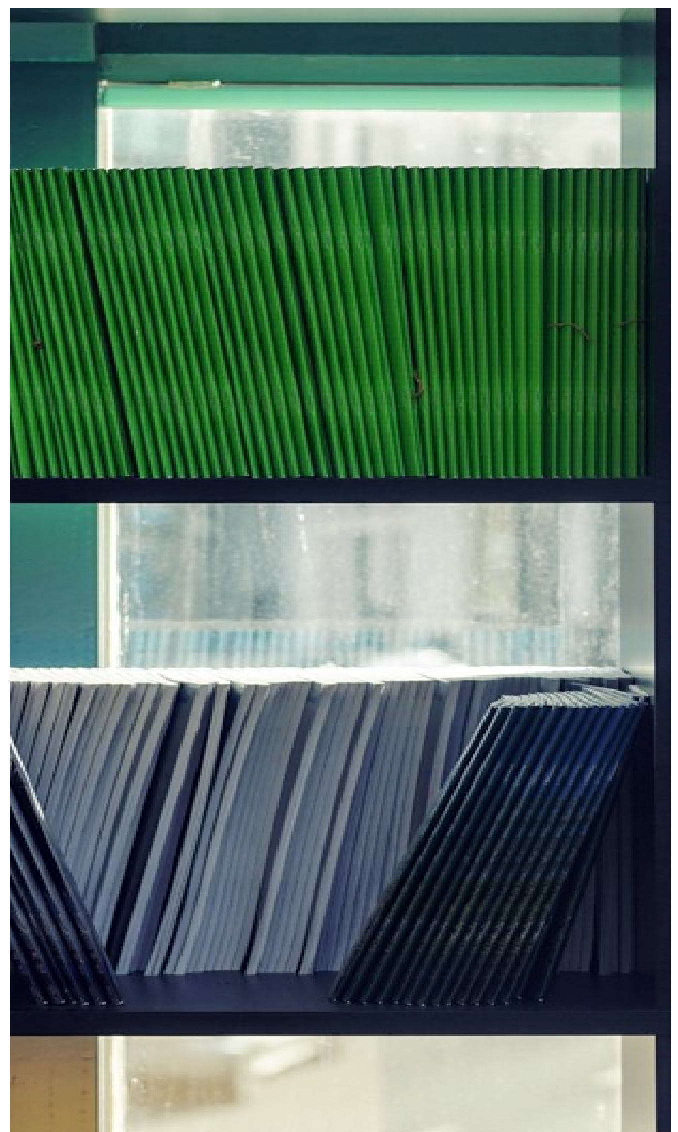
The regulations surrounding VCT qualifying companies is designed to benefit SMEs but is a complex arena to navigate. The relevant definitions and qualifying conditions should be checked with a professional adviser on each occasion. As such, it is crucial to consider obtaining professional advice regarding whether your company is eligible for VCT investment.

Investment strategy

VCTs typically focus on sectors like technology, healthcare, and renewable energy, showcasing the evolving landscape of emerging industries. This diversification helps mitigate risks associated with early-stage companies. By spreading investments across high-growth sectors, VCTs aim to capture potential upsides, enhancing overall returns. They often focus on companies with strong growth prospects and innovative solutions, increasing the prospect of substantial returns for investors.

VCTs provide investees with crucial funding to fuel their growth and innovation. By offering a steady source of capital, VCTs enable early-stage companies to scale their operations, develop new products and expand into new markets.

By James Bryce, James Cashman, Gabriella Rasiah and Mark Dimitri



Limitations of liability in venture capital transactions – key provisions and negotiation points

Venture capital investors will typically include provisions in their transaction documents which may, in certain circumstances, give them a right to claim damages from the target company ("Target") and/or the existing/founder shareholders ("Founders"). A key concern for the Target/Founders will be limiting their potential liability under such provisions.

Warranties

Warranties are one of the most commonly sought protections. Warranties are statements of fact given by Target and/or the Founders (together, the "Warrantors") to the investor at exchange/completion. The warranties will typically cover information about the Target, its business and the accuracy of information provided to the investor (e.g. Target's business plan and share capital). If a warranty is untrue and the investor suffers a loss as a result, it may be able to claim damages from the Warrantors.

Methods of limiting liability

Warrantors can seek to limit their liability by:

- amending the warranties by making them subject to materiality or knowledge or by deleting particularly onerous ones;
- informing the investor of any circumstances which make any of the warranties untrue (a process known as 'disclosure');
- obtaining warranty and indemnity insurance; and
- including limitations of liability in the relevant documentation.

Key limitations of liability

Financial

The most common financial limitations are:

- Cap – this sets the maximum amount of damages the investor can claim. In relation to Target's liability, the cap will usually be an amount equal to the investor's investment plus any recovery costs. The Founders' liability would typically be capped at a multiple of their salary, though it is notable that the recently updated BVCA model documents no longer anticipate the Founders giving commercial warranties (akin to the US market). However, in our experience, investors still consider it important for the Founders to have 'skin-in-the-game' and provide commercial warranties.
- Disregard – if included this will usually be set at a few hundred pounds. Any claim under that amount

will be disregarded. The idea is to prevent trivial claims and add an element of materiality. The investor may not agree to a disregard especially if it agrees to a 'threshold'.

- Threshold (or basket) – this would be set at a higher amount than a disregard (usually between 0.5% and 1% of the investor's investment). The Warrantors would not be liable for any damages until the investor has accumulated warranty claims with a value in excess of the threshold. Again, the intention is to introduce an element of materiality.

- The recently updated BVCA model documents do not include a 'disregard' or 'threshold'. The rationale for this was to seek to simplify the limitation provisions and avoid unnecessary negotiations – it is yet to be seen whether the market adopts this approach.

Time

A time limit for the investor to notify the Warrantors of any claims is usually agreed. This is typically between 18 months and two years (or in the case of any tax warranties, seven years due to HMRC's investigatory powers). The rationale is that any potential issues should come to light within this timeframe, and it prevents the Warrantors having an open-ended liability.

Warrantors may also seek a requirement for the investor to commence proceedings within a few months of notifying a claim. This is to ensure any claims are dealt with as soon as possible.

Others

Other commonly agreed limitations include:

- requiring the investor to make claims against third parties in respect of the matter giving rise to the breach (if it has such claims); and

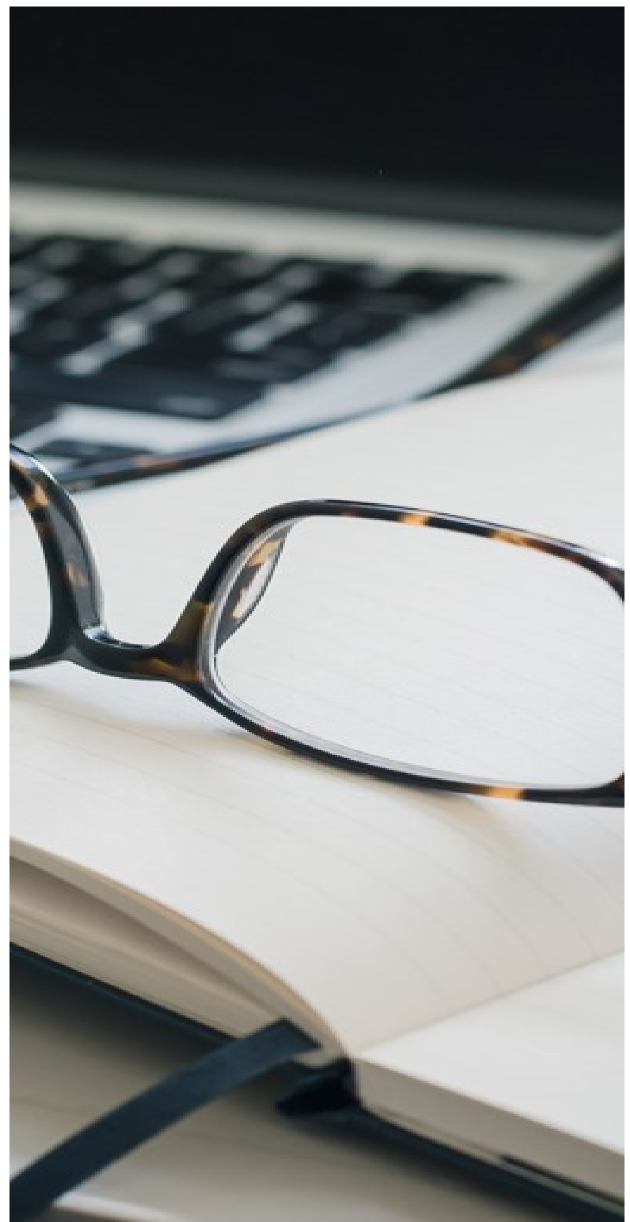
- excluding liability where a breach has arisen due to a post-completion change in law, taxation, or accounting policies.

Limitations may not always apply

It is common for limitations to fall away if a breach results from the fraud, dishonesty, or wilful concealment of the Warrantors. The Warrantors may argue that this should only apply to those Warrantor(s) guilty of those acts, but the investor may reject this on the grounds that the Warrantors should take collective responsibility.

The investor may also insist that some or all of the limitations do not apply to claims under specific warranties (e.g. warranties relating to Target's share capital) because those warranties are so fundamental to its understanding of Target and its investment.

By Stephen Hardwick, Gemma Gallagher and Ellis Hart–MacLeay.



Key trends in the UK Venture Capital Market: resilience amidst challenges

The UK venture capital (VC) landscape has faced significant headwinds in 2024, with deal making set to hit its lowest level since before the pandemic. As of Q3 2024, £10.9 billion has been invested across 1,879 deals, down from £15.5 billion and 3,138 deals in 2023. Despite this, London continues to be a European leader, raising £5.6 billion in Q2 alone.

Sector Shifts: Energy, Health and Robotics in the Spotlight

The UK VC market has seen notable sector shifts. Energy and health tech have attracted increasing investment, driven by the global focus on sustainability and healthcare innovation. Robotics has also risen in prominence, experiencing a 147% increase in investment. Conversely, fintech has seen a 65% decline as investor priorities shift to sectors promising more sustainable growth.

Focus on Sustainable Growth over Scale

In response to shifting market dynamics, UK VC firms are increasingly prioritizing sustainable business models over "growth at all costs" strategies. Investors are focusing on companies with solid unit economics, strong margins, and clear paths to profitability. This shift reflects the broader global trend of cautious capital deployment, as macroeconomic conditions remain volatile. Start-ups that demonstrate resilience and adaptability, particularly in sectors like climate tech and healthcare, are increasingly being favoured by VC firms

M&A Activity: Consolidation in the VC Space

The decline in exit opportunities through initial public offerings (IPOs) has spurred a rise in mergers and acquisitions (M&A) activity in the UK VC market. With fewer IPOs, start-ups are looking at consolidation as a viable exit route. This trend is particularly pronounced in sectors like fintech, where larger players are acquiring innovative start-ups to enhance their service offerings. M&A deals are increasingly becoming the preferred exit for VC-backed firms, providing liquidity in an otherwise subdued exit market.

Diversifying Investor Base: CVCs and Early-Stage Funding Rise

Another key trend is the diversification of the investor landscape. Corporate Venture Capital (CVC) now accounts for 16% of deals, reflecting heightened corporate interest in start-ups. Early-stage funding has remained more resilient, with early-stage deals contributing 27.9% of overall deal value in 2023, up from 19.3% in 2022. This indicates a growing focus on supporting innovative ideas from their inception as both domestic and international investors seek promising opportunities.

Government-Backed Initiatives Encouraging Innovation

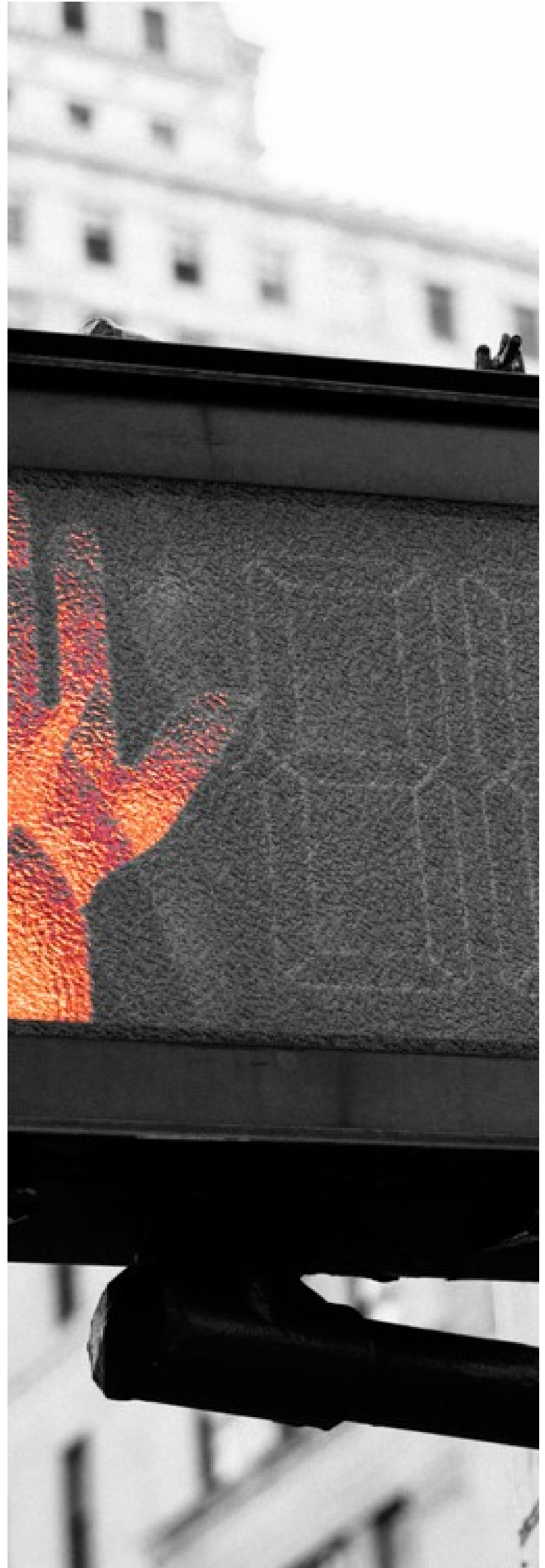
The UK government has announced several initiatives to boost the start-up ecosystem, including a £3.5 billion investment in the tech sector, with £1 billion dedicated to advancing supercomputing and AI technologies. This funding aims to foster innovation and support companies engaged in quantum technology and generative AI. The government is also encouraging regional investment to level the playing field, focusing on areas like Glasgow and Manchester. These measures aim to enhance research and development, ensuring that the UK remains a competitive landscape for venture capital.

Emerging Trends in Deal Terms

Recent trends indicate a movement towards greater standardization of deal terms, driven by the British Private Equity & Venture Capital Association (BVCA). New model documents have been adopted, simplifying deal processes and aligning expectations across the market.

The use of more investor-friendly terms, including participating liquidation preferences and anti-dilution protections, has become increasingly common. These changes reflect a cautious approach from investors in the current economic climate.

By Will Munday, Kartik Monga and Tahmina Begum



Top 10 technology trends in 2025 for Venture Capital investors

The technology sector in 2024 has evolved rapidly, with advancements across artificial intelligence ("AI"), cybersecurity, climate tech, and more. Looking ahead, these trends are set to reshape industries and capture the attention of venture capital ("VC") investors looking to capitalize on the next big innovation. Here are ten technology trends we expect to shape the landscape in 2025, along with our reflections on their commercial impact.

Hybrid AI: moving beyond experimentation

Hybrid AI refers to the integration of multiple AI methodologies, combining traditional machine learning techniques with advanced neural networks, symbolic reasoning, and human expertise, to create more versatile, adaptive, and accurate systems. This approach allows AI models to perform complex tasks that require both structured data processing and intuitive, human-like decision-making. Notable examples of hybrid AI include Google DeepMind's AlphaFold, which blends deep learning with traditional physics-based models to predict protein folding, which has significant implications for drug discovery and medical research. Another example is Microsoft's Azure AI, which combines reinforcement learning with pre-trained models to optimize business processes.

What to Watch: As an increasing number of businesses implement hybrid AI systems, their complexity and decision-making based on both data-driven algorithms and predefined rules, raise questions about accountability—particularly if the AI makes incorrect or harmful decisions.

Early entrants in this industry may benefit from the current lack of clear legislation surrounding AI in the UK. However, first movers must be prepared to accept the risk of potentially building or relying on systems that are incompatible with future more comprehensive AI regulations (such as the EU AI Act and the EU's Directive 2001/29/EC (on Copyright and the Digital Single Market)), once these take shape and are enacted. Providers and users must now carefully weigh the advantages of first-mover benefits against the risks of future compliance challenges and unforeseen legal consequences.

Ethical AI: driving responsible tech development

As AI systems become more embedded in everyday life, ethical concerns around their design and deployment are growing. Companies, including IBM with its Watson suite, and Microsoft with its Responsible AI Standard, are emphasizing transparency and responsible AI use in their deployments across industries. These efforts reflect the growing focus on ensuring that AI systems are fair, accountable, and transparent.

What to Watch: Regulators are likely to apply ethical AI considerations within future regulation, especially as the UK and EU lead, albeit in varying degrees, in promoting responsible tech. Companies prioritizing fairness, accountability, and transparency in AI development are likely to stand out as industry regulatory standards continue to become more exacting.

Climate Tech: addressing sustainability goals

Climate tech solutions, from carbon capture to energy-efficient building materials, are gaining momentum. UK-based Carbon Clean for instance, is pioneering CO_2 capture technology, while AMP Robotics uses AI to improve recycling processes. Both are pushing boundaries in sustainable innovation, taking strides towards addressing climate challenges. These trends are fuelled by the growing focus on sustainable business and combatting climate change, from governments, supranational organisations, and investors.

What to Watch: Investors are increasingly interested in how climate tech companies meet environmental standards and their adherence to the latest ESG requirements, particularly in light of the UK's target of "net-zero" by 2050. This heightened interest focuses on environmental requirements like carbon footprint reduction, sustainable resource usage, and climate-related risk disclosures, as well as social aspects such as community impact, workplace diversity, and ethical business practices. This focus aligns with global sustainability goals and the COP29 outcomes. As the world prioritizes climate resilience and carbon neutrality, these investments are driving transparent, impact-driven solutions that support a sustainable and low-carbon future.

Quantum Computing: entering early commercialisation

Quantum computing is an emergent field of cutting-edge computer science harnessing the unique qualities of quantum mechanics to solve problems beyond the ability of even the most powerful classical computers. Its potential applications are vast, from financial modelling to drug discovery. Rigetti Computing and D-Wave are two companies actively working toward scalable quantum solutions. Though still in its early stages, the field is progressing, particularly in industries requiring complex data analysis and advanced computational power.

What to Watch: Quantum computing's unique potential has led to increased regulatory attention, particularly for IP and export control. In the EU and UK, quantum computing innovations will be governed by patent regulations under the European Patent Convention (EPC) and UK Patent Act, as well as trade secrets regulation through the EU Trade Secrets Directive and the UK Trade Secrets Regulations among others. However, quantum technologies may also be subject to export controls under the EU Dual-Use Regulation and UK Export Control Regulations, restricting the export of sensitive technologies with military or dual-use applications. For companies developing quantum solutions, securing early IP rights and obtaining export control advice will be essential for long-term growth and competitive advantage.

Digital Identity and decentralized finance ("DeFi"): redefining security and finance

Blockchain-based digital identity platforms are creating more secure, decentralized ways to verify and control personal data. Examples include Civic, which offers distributed ledger digital ID solutions, and Compound, a leader in DeFi that enables secure, decentralized lending and borrowing.

What to Watch: DeFi and digital identity ventures are grappling with complex anti-money laundering and 'know your customer' due diligence requirements. Companies that can maintain robust compliance while offering user-friendly solutions may gain an edge in a fast-evolving space.

Cybersecurity: responding to rising threats

Cybersecurity is set to remain a top priority in 2025, with threats escalating in both volume and sophistication. Palo Alto Networks and SentinelOne are notable examples of cybersecurity providers, each offering AI-driven security platforms that help companies detect and respond to cyber threats across Cloud and on-premise infrastructure.

What to Watch: Cybersecurity standards are evolving as a result of regulatory developments, especially in the UK and EU, with a push towards a demand for higher levels of data resilience. Key legal considerations in this area include the rise of EU regulations such as the Digital Operational Resilience Act (DORA), and the updated EU Network and Information Security Directive (NIS2). Providers in this field must prioritize compliance and risk management to mitigate regulatory exposure. In addition, any organisation handling sensitive financial/asset data may be considered critical national infrastructure under the recently passed legislation, and will need to plan its cyber resilience and procurement pipeline very carefully with a focus on the state of the art.

Health Tech: revolutionizing patient care and diagnostics

Health tech innovations are reshaping diagnostics, telemedicine, and personalized care. Tempus, for instance, uses AI to provide cancer treatment insights, while Babylon Health delivers virtual healthcare consultations, improving access to quality medical advice.

What to Watch: Health tech firms must navigate rigorous data privacy and IP regulations, particularly under EU's GDPR, which includes health data in special categories requiring heightened protection. Users of health tech solutions must stay compliant with evolving regulations, ensuring both legal protection and patient trust. For investors, understanding compliance standards will be critical as health data management and privacy become even more central to this field.

IP protection is also crucial, with European Patent Convention (EPC) and UK Patents Act covering patents for medical devices, AI algorithms, and software innovations. Trade secrets protection and copyright laws also play a role in safeguarding proprietary technologies.

Supply Chain Innovation: enhancing efficiency and transparency

Recent supply chain challenges have spotlighted the need for improved logistics technology. Flexport offers digital freight-forwarding services, providing end-to-end visibility and data-driven insights for shippers. FourKites is another example, using AI to enable real-time shipment tracking and predictive analytics.

What to Watch: Supply chain tech investments involve managing data across borders and understanding trade compliance. Ensuring data localization and meeting international standards will be essential for long-term success and operational security.

Edge Computing: powering real-time applications

Edge computing is transforming industries by allowing data to be processed closer to its source —at the "edge" of the network— reducing latency, increasing operating speed, and improving efficiency by minimising the need to transmit large volumes of data to centralized data centres. Nvidia's edge computing solutions, designed to support AI applications in real-time data processing, are used across sectors from autonomous vehicles to healthcare diagnostics.

What to Watch: Edge computing requires strict attention to data privacy and security obligations, especially with GDPR regulations in the EEA and UK. This is because the decentralised nature of edge computing leads to more endpoints being vulnerable to cyber attacks and harder to secure, as well as the limited computational power of edge devices restricting the implementation of robust security measures. Companies operating in this space should prioritize secure data practices and compliance with local and regional standards.

Employee Experience Tech: supporting the hybrid workforce

The rise of hybrid work has boosted demand for technology that enhances employee engagement and productivity. Microsoft Teams and Zoom are well-known examples, constantly evolving to support collaboration and communication for distributed teams. Startups like BetterUp are also gaining attention with digital platforms that support employee wellness and professional growth.

What to Watch: Data privacy is crucial when handling employee information, especially under stringent protections in the EU and UK. Companies should implement robust data security protocols to address the unique challenges that come with managing employee data in a hybrid work environment. Furthermore, securing the right telemetry, hosting architecture and managed services is an essential element to employee-experience technology. As such, companies must take care to ensure that systems and agreements are in place to ensure a seamless hosting experience.

Final thoughts

2025 is set to be an impactful year across these technology trends, bringing fresh opportunities and challenges to the forefront. For companies and investors in these fields, the ability to anticipate regulatory changes and adapt to evolving market demands will be critical for navigating this dynamic landscape. With technological advances reshaping industries and influencing investment strategies, staying attuned to both innovation and regulation will be essential for sustainable growth in the coming years.

There are just as many considerations for the potential customers of these emerging technologies as often, first mover advantage involves taking legal and commercial risks that may be reduced or mitigated for buyers in more developed markets.

By Ben McLeod, Sam Hodgson and Gabriella Rasiah

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DWF's Recent VC Experience

- Acting for Albion Capital on a number of venture capital investments.
- Advising NorthEdge Capital LLP on its investment in Cezanne HR (Holding) Limited.
- Acting for Scottish National Investment Bank on a number of different investments in the technology sector including in Utopi Ltd, Cyacomb, Travelnest and Pneumowave.
- Advising specialist healthcare investor Apposite Capital on a number of minority investments, including in respect of diagnostics company Medical Imaging Partnership.
- Acting for AC TGP I Limited, a company backed by Aliter Capital, on its investment in Temple Grange Partners Limited, a leading financial crime and compliance practice.
- Acting for GMCA on its investment in James Briggs, the maker of vehicle paints.
- Advising a number of family offices of independant successful entrepreneurs on mutiple strategic venture capital investments, including in Glasswall Solutions (cyber security), Evolve Dynamics (Sky Mantis drones and tethers both for civil and military application), FibreCRM (software for professional services businesses) and Actus (performance and talent management software).
- Acting for the Aventum Group on its minority equity investments into numerous insurance MGA and brokerage companies.
- Advising Cartesian Capital Group on its investment into Simba Sleep Limited.
- Acting for TDR Capital in respect of its equity and debt investments in a Fintech company.
- Advising the BPP Group on its minority equity investment in an EdTech company.
- Acting for AFM on its investment in AFM Wealth Limited.
- Advising Enter Air on its investment in the Swiss company Germania Flug.
- Acting for Lavanda Ventures Ltd on an equity investment from Finch Capital and Concrete Partnership.
- Advising Arajet Holdings Limited on the investment into it by Bain Capital Griffin International Master Fund, L.P. through its Spanish subsidiary HULANSERA, S.L., to create the first Dominican Republic based airline.
- Acting for Cellnovo Limited, a medical device company, on an initial investment to provide funds to develop its starlet range of drug infusion products together with subsequent funding rounds raising in aggregate of £40m.
- Advising the founder shareholders of BioSure (UK) Limited (a company in the biotech sector) in the raising of initial seed capital and, subsequently 3 further rounds of capital raising from, amongst others, Moulton Goodies Limited.
- Acting for Midnite, an esports and sports betting company, on its Series A and Series B funding rounds.
- Advising Octagon I/O Limited (trading as Converge), an early stage technology company, on its Series A equity funding round which included an investment from OGCI.
- Acting for the Ministry of Defence software supplier, Adarga, on its £17m Series A funding round.
- Advising Keywords Studios PLC, the AIM listed Games' company on a number of venture capital investments in the games' sector.
- Acting for RideZoomo, an electric bikes leasing company, on its seed and Series A equity funding rounds which included investment from a number of venture capital funds.
- Advising Cirrus Response in relation to an equity investment in the company by BGF.
- Acting for Mura Technology Limited on the investment made by Dow Chemicals and on a separate investment by Kellogg Brown & Root (KBR).
- Acting for The Greater Good Fresh Brewing Co Limited in a number of successive venture capital fundraising rounds.
- Advising Pets Love fresh on its seed and Series A funding rounds.

Meet the team

A Collaborative VC Team

With our standing and presence in the market, DWF can rely on an extensive network of skilled lawyers in various jurisdictions to provide our clients a seamless and co-ordinated approach to venture capital transactions.

In addition, we draw on recognised experts in key industry sectors and specialist areas of law, making us well placed to advise on the full range of transactions.

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