

BVCA MODEL DOCUMENT

ARTICLES OF ASSOCIATION: DRAFTING NOTES

General

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

- The principal contractual document is a subscription and shareholders agreement (often referred to as an investment agreement). This often takes the form of a single document but it may be split into two separate documents, a subscription agreement and a shareholders or investors' rights agreement.
- The other key document is the new articles of association of the company in which the investment is being made (the "**company**"). The articles of association form part of the company's constitution and as such govern the internal management of the company's affairs. The articles are subject to the requirements of the Companies Act 2006 (as amended) (the "**Act**").

What are the articles?

The purpose of the articles of association is to regulate the internal management of the company and how power and control is shared between the shareholders (also known as members) of the company and the directors. They also regulate how rights of different classes of shareholders operate among themselves.

Frequently companies adopt a standard default form of articles of association as prescribed by statutory instrument. In the past, this was usually the form of articles known as Table A in the Companies (Tables A to F) Regulations 1985 (SI 1985/805), as amended ("**Table A**"). For companies incorporated on or after 1 October 2009, the default form of articles for private companies limited by shares is the model articles for private companies limited by shares set out in Schedule 1 to the Companies (Model Articles) Regulations 2008 (SI 2008/3229) (the "**Model Articles**"). Companies formed before that date still have Table A as their default articles, unless disapplied. Venture capital transactions usually call for a complex share structure, and a number of articles, which are common only to an investment of private equity. (*See further article 1, below*).

The provisions of a company's memorandum of association (other than the subscriber details) are, since 1 October 2009, now treated as forming part of the articles. The memorandum has, therefore, lost its significance as a constitutional document.

The provisions of a company's articles of association bind the company and each of its shareholders as if there were covenants on the part of the company and of each shareholder to observe those provisions (*section 33, Act*). The articles must be filed with the registrar of companies and are therefore available to the public.

Members will, therefore, have contractual as well as statutory remedies, for example, actions for unfair prejudice (*part 30, Act*) for breach of the articles. However, the protection that this gives to the shareholders has been eroded by the fact that:

- Third parties dealing with the company in good faith can rely on the directors' unfettered power to bind the company, whatever the articles say (*section 40, Act*). (Note that the court of appeal held in *EIC Services Limited and others v Stephen Phipps and others [2004] EWCA Civ 1069* that it cannot be inferred that section 35A of the Companies Act 1985 (the predecessor to section 40 of the Act) applies to shareholders who deal with the company.)

- Although the articles bind the members, it is not entirely clear the extent to which one member can enforce the rights contained in the articles against another member, other than through the medium of the company.
- The articles cannot deal with matters that are personal to the members, such as provisions dictating how members will exercise their voting rights, if this could be seen as unlawfully fettering the company's statutory powers. Such matters can however be addressed in the investment agreement.

The investment agreement binds only the parties to it, which will usually be management, the company and the shareholders and is a private contract between such parties which does not have to be filed at Companies House. The parties should consider the issue of confidentiality and whether there are provisions which they would prefer not to be in the public domain and so insert these into the investment agreement. Care should also be taken to ensure that the articles are consistent with the investment agreement. The usual approach is to provide in the investment agreement that, in the case of disputes, the investment agreement prevails (*see clause 28, investment agreement*).

Article 1: Introduction

A company incorporated on or after 1 October 2009 may adopt either articles in the form of the Model Articles, modified by special articles, or long-form articles of association drafted specifically for the company and disapplying the Model Articles entirely.

The BVCA model articles adopt the Model Articles, as modified by the special articles set out in the BVCA model articles.

This approach means that each of the provisions of the Model Articles should be considered in order to determine those that are applicable and to ensure those that are not needed (or which are contradictory to the tailored articles) have been specifically disappplied (*see article 1.4(c)*).

If the company was formed before 1 October 2009, then Table A will still be its default articles unless disappplied. Therefore, even if such a company wants to apply some or all of the Model Articles, it should expressly disapply Table A to ensure that none of its provisions are applied unintentionally (*see article 1.2*).

The provisions of the Model Articles that have been deleted relate to the following issues:

Article of the Model Articles	Contents	Alternative provision (if applicable)
8(2)	Unanimous decisions	Article 30.8
9(4)	Calling a directors' meeting	Article 30.4
10(3)	Participation in directors' meetings	Article 30.3
11(2)	Quorum for directors' meetings	Article 30.1
13	Casting vote	Article 30.6
14	Conflicts of interest	Articles 30.5 and 31
17(2) and (3)	Methods of appointing directors	-

19	Directors' remuneration	Covered by Shareholder and Subscription Agreement and contracts of employment
21	All shares to be fully paid up	_*
26(5)	Share transfers	Article 14.6
27	Transmission of shares	Article 18
28	Exercise of transmitters' rights	Article 18
29	Transmitters bound by prior notices	-
30(5) – (7)	Procedure for declaring dividends	Article 4
44(4)	Poll votes	Article 23.5
51	Provision for employees on cessation of business	-
52	Indemnity	Article 33
53	Insurance	Article 33

* *The BVCA model articles are prepared on the basis that the company may issue shares nil or partly paid.*

Article 2: Definitions

Great care should be taken with definitions as the construction of key parts of the articles depends on them. Care should also be taken to ensure that definitions used in the investment agreement and the articles are consistent.

The main purpose of including a definitions article is to reduce repetition within the body of the document, making it shorter and easier to read. Therefore, it is common practice to include an article setting out the defined terms at the start of the document. This alerts the reader to the conventions to be applied in the articles that follow. Where terms are used only in a specific article, additional definitions may be included in that article (*for example, see article 20 of the BVCA model articles*).

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

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

Acting in Concert

Under the City Code on Takeovers and Mergers, people act in concert when they agree to co-operate to obtain control of a company.

Associate

Associate is defined with reference to section 435 of the Insolvency Act 1986, which sets out the various relationships that comprise an association. These include family relations, employment, trust relations and having control of companies. In addition, in these articles members of the same group of companies and members of the same fund group are defined as "associates".

Authorised Share Capital

The concept of authorised share capital is not found in the Act, as companies are no longer required to have authorised share capital (although they may include in their articles a limit on the number of shares that may be allotted). If a company wants to include such a limit, then it is helpful to define this limit, for ease of reference in the articles.

Available Profits

This definition refers to profits available for distribution within the meaning of part 23 of the Act, which defines profits available for distribution (briefly) as a company's accumulated realised profits (so far as not already utilised) less its accumulated realised losses (so far as not previously written off).

Bad Leaver

This definition should be read together with the definition of good leaver. The definition will be important in determining whether an employee's shares should fall within the compulsory transfer provisions set out in articles 18 and 19 of the BVCA model articles.

A bad leaver is any employee who leaves the company for any reason other than those set out in the definition of good leaver. So, for example, a bad leaver may be someone that has breached his contract of employment or someone who resigns from the company within a given period following completion of the investment round. Founders may be excluded from the definition of "bad leaver" on the basis that they are already subject to certain vesting of share provisions contained in article 8 of the articles. If, however, a view is taken that the founders should also be required to transfer any of their vested shares under article 19, the words "other than a founder" should be deleted from this definition.

Commencement Date

This definition is linked to, and should be read in conjunction with, the definition of Relevant Period and article 8 (vesting of ordinary shares, *see below*).

The commencement date is the date on which a founder (or employee) starts his employment with the company. Any shares that are then issued to the founders will be vest over the relevant period in this case 48 months, and if the founder leaves the company between the commencement date and the end of the relevant period he will be disenfranchised of a proportion of the shares held by him.

Consider whether the commencement date should be the date that the founder or employee starts his employment with the company, or whether it should be some other date such as the date on which the articles are adopted although in practice, the founders will firmly resist this.

Controlling Interest

This is defined with reference to the Corporation Tax Act 2010 which (broadly) defines control as the power of a person to control the affairs of a company, by holding shares or voting power in it or by any powers conferred by the articles of association.

Deferred Shares

These shares (which are often referred to as "non equity" shares) carry no voting or dividend rights. In certain circumstances, a founder's ordinary shares will automatically convert into deferred shares and so the rights attaching to them must be set out here. (*See article 8, below.*)

Effective Termination Date

This definition is important in the context of the vesting of the founders' shares, article 8, and good and bad leavers, article 19, and should be read together with those provisions. The termination date of a person's employment with the company is the date on which any applicable notice periods (if any) under their contract of employment have expired or if earlier, a date that the employee or the company agree.

Encumbrance

This term can be widely construed, and may include many kinds of restrictions on a person's ability to deal freely with shares (or assets) in their ownership and control. Always consider the context in which the term is used.

Fair Value

This is the amount to be paid for the shares in the company following certain events, for example, on the deemed issue of a transfer notice. The fair value for the shares must be determined in accordance with article 17.

Family Trusts

This definition should be read together with the definitions of permitted transfer and the provisions of article 15 (*see below*). In certain circumstances the shareholders (particularly the founders and employees) will be allowed to transfer their shares freely, enabling them to make full use of all available tax allowances. Transfers are usually allowed to family trusts, the definition of which may be narrowly drawn (and only to an specific family trust that is already established, in which case it is quite common to include the name(s) of those trusts in the definition) or may be drafted in more generic terms. The BVCA model articles follow the latter approach.

Good Leaver

(*See the definition of Bad Leaver, above.*) This definition will be important in determining whether an employee's or founder's shares should be subject to the compulsory transfer provisions set out in article 19.

As drafted, a good leaver will be any person who ceases to be an employee of the company, at any time, as a result of death, permanent incapacity, termination of his employment by the company where he is not in breach of his contract, wrongful or constructive dismissal by the company or where an investor majority determines that an employee is a good leaver.

The articles provide for an optional good leaver situation so that any person who ceases to be employed by the company four years after the commencement date (*see above*) of his employment will be a good leaver. Consider whether this four year period is acceptable, and

whether the period should run from the start of the employment (which may be before the investment is made), or from another date, such as the adoption of the articles.

Note that this definition may be extended to cover founders; if the provisions of article 19 on compulsory transfers extend to founders then the words “other than a founder” in square brackets in this definition should be deleted.

Investor Consent

This is one of the protections that the investors will insist upon in any round of investment. In addition to board approval, certain day-to-day issues will also require the consent of the investor directors (and possibly the investors themselves).

The BVCA model articles provide for this to be the consent of the investor directors. In circumstances where one of the investors has not appointed a director, the BVCA model articles provide in the alternative for it to be either the consent of the relevant investor or the investor majority.

Care should be taken to ensure that this definition is consistent with clause 9.3 of the BVCA model investment agreement.

Investor Directors

Investors will insist that they have representation on the board and have an entrenched right to appoint directors to the board of the company. This is provided for in article 28.1 below.

Investor Majority

Certain shareholder type matters will require the consent of a specified percentage of the series A shares.

Even if the investment is not syndicated at the outset and there is a single investor, this definition should remain in the articles, since the original investor may transfer some of its shares to its permitted transferees (*see below*) or may sell or transfer some of its shares to another investor at a later date.

Leaver's Percentage

This definition should be read together with article 8. It relates to the number of the founder's ordinary shares that convert to deferred shares when a founder leaves the company before the end of the relevant period (48 months). This is calculated as a percentage, taking into account the length of the founder's service with the company; the longer the founder is employed by the company, the fewer ordinary shares that convert to deferred shares.

Member of the same Fund Group

This definition will be important to the investor, and relates to permitted transfers that the investor is able to make. Together with the permitted transfer provisions in article 15, it allows the investor to transfer its shares to:

- other funds managed by the same fund manager;
- participants and partners of the fund manager;
- parent and subsidiary companies of the fund manager; and
- the trustees or custodians of the fund manager.

It will be a matter for negotiation between the parties as to how widely (or narrowly) this definition is drafted.

Member of the same Group

This definition should also be read in conjunction with the permitted transfer provisions in article 15. Together they enable a corporate shareholder to transfer shares to other companies within the same group.

Non-qualifying IPO

This is an initial public offering where the company does not meet the market capitalisation for a qualifying IPO and therefore triggers the capital preference provisions in article 6.3. Consider whether this definition is necessary or whether the definition of IPO is sufficient.

Permitted Transfer

This relates to a transfer that is allowed under article 15 (*see below*) without triggering the offer procedure in article 16. These provisions enable shareholders to transfer their shares in the company, freely, to a restricted group of individuals and corporate entities. The extent to which such transfers are permitted will be a matter for negotiation between the parties.

Permitted Transferee

This sets out specific details of the persons and/or entities to which each type of shareholder is allowed to transfer its shares freely under article 15 (*see below*). It should be read together with the definitions of family trust, trustee, privileged relations, member of the same fund group and member of the same group.

Individual shareholders are permitted to transfer their shares to privileged relations (spouse, civil partner, children (including adopted children, step children and illegitimate children) and grandchildren) or to the trustees of any family trust (*see Family Trust, above*). Consider whether this definition should be extended to cover the original shareholder's siblings.

Corporate shareholders (referred to here as "undertakings (as defined in section 1161 of the Act)") are able to transfer their shares to members of the same group (parent and subsidiary undertakings of that company, and other "sister" companies where the corporate shareholder has a parent company) (*see Member of the same Group, above*).

Shareholders that are funds (often the investors), may transfer their shares to other members of the same fund group (*see Member of the same Fund Group, above*).

The investors are also able to transfer their shares to other members of the investor group, to other investors and to other financial institutions and institutional investors. As this is quite a wide group of people, the BVCA model articles provide optional wording for the latter group of transferees to be approved by a majority of the directors.

Preference Amount

This definition relates to the amount which the series A shareholders are entitled to on a distribution of assets, liquidation, return of capital, a share sale of the company or an asset sale and should be read together with articles 5 and 6 (*see below*). In these articles, the preference amount is an amount equal to the subscription price paid (or deemed paid) for the series A shares (including any premium) together with a sum equal to all arrears of dividends accrued down to the relevant date of payment (rather than to the liquidation event) although this can be varied so the investor receives a multiple of the subscription price paid.

Pre-New Money Valuation

This definition is included for the purposes of article 6.3 and values the company immediately following a Qualifying IPO or, an IPO, as the case may be, at the issue price of shares in the IPO. This valuation will assume that all the series A shares have converted into ordinary shares pursuant to the IPO, but it will exclude from the calculation any new shares issued in the IPO.

Privileged Relation

As noted above, this definition is important in the context of the persons to whom an individual shareholder is able to transfer its shares in the company freely, without the need to go through the pre-emption requirements. This extends to the spouse, civil partner, children (including adopted children, step children and illegitimate children) and grandchildren of the original shareholder and to the trustees of any family trust (*see Family Trust, above*). Consider whether this should be extended to cover the original shareholder's siblings too.

Qualifying IPO

A qualifying IPO is an initial public offering that gives the company a market capitalisation of at least a certain amount. Under the provisions of article 9 all of the series A Shares automatically convert into ordinary shares on the date of a qualifying IPO. The investors will be keen to ensure that on an IPO the company reaches a particular market capitalisation, this is usually calculated by reference to the valuation of the company at the time that the investment is made.

Consider whether this definition is necessary, or whether the definition of IPO is sufficient.

Realisation Price

This is the value of each ordinary share in the company immediately prior to an IPO, calculated by reference to the price at which the company's shares are to be offered for sale in the IPO.

Relevant Period

This definition is linked to the vesting of shares issued to the founders in article 8 and to the compulsory transfer of shares in article 19.

Article 8 of the BVCA model articles provides that the period over which the founders' shares will vest is 48 months from the date that the founder begins his employment with the company (*see Commencement Date, above*). If the founder leaves the company during this period, a percentage of the shares held by the founder will vest (*see Vested/Unvested, below*), the remaining shares will convert into deferred shares. The percentage that the founder receives is on a sliding scale, and is defined in the articles as the leaver's percentage (*see Leaver's Percentage, above*).

Consider whether this is an appropriate period, or whether it should be longer.

Series A Shares

These are equity shares with preferential rights and can also be defined as A ordinary shares, preferred ordinary shares, cumulative convertible participating preferred ordinary shares or cumulative preferred ordinary shares. Regardless of which name they have, they rank ahead of the ordinary shares for income and capital (*see articles 4.2 and 5(a) below*), being entitled to a fixed dividend and to participate in further dividends if the company has distributable profits (*see article 4.8, below*).

Starting Price

This is usually the per share subscription price paid by the Investor for the Series A Shares. It is used in article 10 to determine whether there has been an issue of new securities which triggers the anti-dilution protection provisions.

Unvested/Vested

This definition relates to shares that are issued to founders, employees and/or consultants of the company. Under article 8 of the BVCA model articles, if the founders cease to be employed by the company before the end of a certain time period (*see Commencement Date and Relevant Period, above*) a percentage of their ordinary shares (the leaver's percentage) automatically convert into deferred shares and are said to be "unvested". Shares that are not capable of being converted, because the founder ceases to be an employee after the relevant period or, if he leaves during the relevant period, because they fall outside the leavers percentage will be said to have "vested".

Article 3: Share capital

Article 3.1

This article is only for use where a company wants to retain the concept of authorised share capital.

Since 1 October 2009 companies are no longer required to have authorised share capital, unless required to do so by their articles. For companies incorporated before 1 October 2009 their existing authorised share capital will be treated as a provision of their articles setting a limit on the maximum amount of shares that may be allotted by the company, unless that provision is removed.

If the company wants to have an authorised share capital-type limit, article 3.1 can be used to set a limit on the amount of shares that may be allotted by the company. Article 3.1 provides that this limit may be varied by ordinary resolution (mirroring the level of resolution previously needed to increase authorised share capital). The limit may be a nominal amount of capital or may be further detailed as the specific amount of series A shares and ordinary shares that may be allotted.

Consider carefully whether this limit is needed. There are additional protections available to the shareholders on an issue of shares, including the requirement for investor consent under the investment agreement, the need for authority to allot and pre-emption rights, which may mean that a limit on the amount of shares that may be allotted is unnecessary.

Article 3.2

This article is not needed if article 3.1 is removed. Article 3.2 clarifies that the maximum amount of shares that may be allotted is not reduced by a redemption or buyback of shares, unless the company resolves otherwise (mirroring the position under section 160(4) of the Companies Act 1985).

Article 3.3

This article states that, unless the context requires otherwise, references to shares of a particular class shall also include all shares of that class even if they are allotted and/or issued after the date on which the articles are adopted. The purpose of the article is to ensure that all shares of a particular class rank equally, and the only difference is the date from which any further shares that are issued rank for dividends (this is likely to be the date from which those shares are issued rather than for an entire dividend period which may have started to run before the additional shares were issued).

Article 3.4

This article makes it clear that the series A shares and the ordinary shares are separate classes of shares. This means that the rights attaching to the investors' shares (the series A shares in the BVCA model articles) are incapable of amendment without the consent of the investors, in accordance with the provisions of *article 12 below*.

Article 3.5

This article contains provision to deal with fractions on a consolidation of shares. This provision was previously found in Table A, but is not included in the Model Articles.

Article 3.6

This article replicates a provision previously found in Table A, enabling the company (with the authority of an ordinary resolution) to provide for differing rights attaching to different shares resulting from a sub-division or consolidation.

Article 3.7

Under section 685 of the Act, directors may be authorised in a company's articles to determine the terms, conditions and manner of redemption of redeemable shares and article 22(2) of the Model Articles contains this authorisation. As these rights are typically set out in the articles as determined by the shareholders, this authorisation has been disapplied (see Appendix B: Redemption below).

Article 3.8

This article amends paragraph (c) of article 24(2) of the Model Articles so that share certificates are required to state the amount paid up on them (rather than stating always that the shares are fully paid).

Article 4: Dividends

Article 4.1

Part 23 of the Act relates to the distributions made by a company, and include dividends. The effect of these provisions is, broadly, that a company is prohibited from making a distribution to shareholders out of unrealised profits. Section 830 of the Act provides that a company cannot make a distribution except out of profits "available for the purpose" which include its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses so far as not previously written off in a reduction or re-organisation of share capital. In addition, the directors must also promote the success of the company for the benefit of the members as a whole; for example if they paid a dividend without due regard to the company's future solvency or its cash requirements, they may be liable. The purpose of article 4.1 and the definition of "Available Profits" in the BVCA model articles are to ensure that only the profits as referred to in those sections of the Act as being available, are applied to pay dividends.

Articles 30(2) and 32 of the Model Articles will not apply to the preference dividend as they are inconsistent with its terms, but they will continue to apply to any other dividends permitted.

Article 4.2

Any available profits must be used first to pay to the holders of the series A shares, a fixed, cumulative, cash, preferential dividend at the specified annual rate. The BVCA model articles provide in the alternative for this to be calculated on the basis of either:

- a fixed amount per series A share; or
- a percentage of the issue price of the series A shares.

As the dividend is expressed to be “cumulative” this means that any dividend that is not paid for the relevant dividend period accumulates until it is paid by the company. Note also, that the dividend should be paid in cash.

The BVCA model articles include alternatives for when the preferential dividend is payable, for example, it may be payable on an exit, an initial public offer or on a conversion, and it may be payable in a number of instalments annually (quarterly or half-yearly on set dates) or on a single date each year. It will be for the parties to determine which is the most appropriate alternative. The BVCA model articles also specify when the first payment should be made.

Article 4.3

Dividends are made to the relevant shareholders pro rata to the number of shares held by them.

This article contains optional wording for use if shares may be issued nil or partly paid shares and it is intended that dividends should be paid according to the amounts paid up on the shares.

Article 4.4

The phrase "or as the directors may otherwise decide" has been removed from paragraphs (a) - (d) of article 31 of the Model Articles to ensure certainty as to the required manner of notifying the company of the desired payment method for a dividend.

Article 4.5

If the company does not have sufficient profits available to pay the full amount of the dividend due on the series A shares, it shall, on the relevant date, pay as much of the dividend as it can, having regard to the maintenance of capital and other provisions of the Act.

Article 4.6

The dividend due on the series A shares automatically becomes a debt due on the date that the dividend is expressed to be payable (*see article 4.2 above*). To the extent that the dividend is not paid in full on that date (*see article 4.5 above*), it attracts compound interest, calculated on a daily basis assuming a 365 day year.

The parties should consider whether it is appropriate for unpaid dividends to attract interest, and if so, the appropriate rate of interest should be considered carefully.

Article 4.7

This article provides that if the company is in arrears in paying dividends on any shares, any profits available for distribution must be applied first in, or towards paying off all arrears of preference dividends due on the series A shares, and second in, or towards, redeeming all of the series A shares that have not been redeemed on or by the due date for redemption in accordance with article 6 (*see article 6: Exit provisions, and Appendix B: Redemption below*).

Article 4.8

This article is primarily for the investors’ benefit, and provides them with further protection on an IPO in respect of accrued and unpaid dividends. In such circumstances, instead of paying the accrued dividends, the company is obliged to pay a special dividend in the form of ordinary

shares, capitalised from the company's reserves. The investors will receive the number of ordinary shares that is equivalent to the amount of the accrued but unpaid dividend on their series A shares. This is calculated by reference to the issue price of the ordinary shares in the IPO.

So, for example, if the amount of dividend accrued and outstanding on the series A shares was £100 and the issue price of the ordinary shares in the IPO was to be £10 per share, the investors would receive 10 ordinary shares by way of the special dividend.

Article 4.9

Aside from the dividend due on the series A shares held by the investors, no other distributions or dividends can be made without obtaining the relevant investors' consent. If this consent is obtained, any further dividends are to be distributed equally to all shareholders *pari passu*, as if there were only once class of share. This means that the series A shares will rank together with the ordinary shares for any further dividends.

Article 4.10 and article 4.11

Article 4.10 provides the investors with a degree of comfort that the dividends due on their series A shares will be paid. The company must procure that the profits of any group companies available for distribution are paid by way of dividend to the company. Similarly, article 4.11 permits the payment of additional interim dividends if the company has sufficient distributable reserves to do so. The parties should consider whether both provisions are necessary, and if so, ensure that they are consistent in their approach.

Article 4.12

This article provides that the company may apply capitalised sums appropriated from profits available for distribution (which are not required for the Preference Dividend) towards paying up any sums unpaid on existing shares held by the persons entitled to those capitalised sums.

Article 4.13

This article provides that if a share is subject to a lien in favour of the company in respect of unpaid share subscriptions and the company is entitled to enforce that lien, the company may instead deduct the money owing to it from the dividend payable in respect of that share.

Article 5: Liquidation preference

A liquidation preference provision is a feature of venture capital investments and sets out details of how the company's surplus assets should be distributed on either a liquidation or return of capital. If the company is solvent, the liquidation preference identifies the priority in which surplus assets are to be applied, following payment by the company of its liabilities. Generally, the series A shares (or other shares held by investors) will rank ahead of other equity shares held by the founders and employees. This is a variation to the usual position under the Model Articles (and previously under Table A) where any remaining assets of the company are divided amongst the shareholders pro rata to their holding of shares.

The holders of series A shares are entitled to receive the preference amount back. The preference amount includes an amount equal to the subscription price paid for each series A share together with the arrears of any dividend due on each series A shares. The arrears of the preferential dividend are to be calculated down to the date of the repayment (that is the return of capital) rather than following the common law rule that, on a liquidation, no arrears are payable in respect of the period after the date of the liquidation. If there are insufficient surplus assets remaining to pay the preference amount in full, the BVCA model articles provide for the surplus amounts to be distributed to the holders of the series A shares pro rata to their

respective shareholdings (*see article 5(a) and definition of preference amount*) of series A shares.

After the holders of series A shares have been repaid, the deferred shareholders receive an aggregate payment of £1 which can be satisfied by making the payment to any holder of deferred shares (*see article 5(b)*).

The BVCA model articles provide for any remaining surplus assets to be distributed among the holders of equity shares, pro rata to their holding of equity shares.

The form of the liquidation preference should be considered carefully. For example, should the amount that the investors receive in preference to the other classes of shareholder be equal to the amount of the investors' original investment, or a multiple of it?

Careful consideration should also be given to the circumstances in which the liquidation preference applies. For example, should the liquidation preference apply only in connection with a liquidation or winding up (as in the BVCA model articles). Article 6 of the BVCA model articles is drafted so that the provisions of article 5 apply to a sale of the company's assets, shares or an IPO (*see article 6 below*).

Article 6: Exit provisions

One of the investors' key objectives will be to exit from their investment in the company within a specific time period (often five years). The most common forms of exit are either an IPO or a trade sale (of either the business or the shares). The purpose of this article is to identify how the proceeds of a share or asset sale are to be applied, or what happens to the series A shares on an IPO.

Article 6.1

This article provides that the proceeds of sale (including any deferred consideration or consideration shares) received by the company's shareholders should be distributed in the same order of priority as on a liquidation (*see article 5 above*). The directors can only register the transfer of the shares if the proceeds of the sale have been correctly distributed (*article 6.1(a)*).

Article 6.2

If the exit is by way of a sale of the company's assets, following payment of the company's liabilities, the surplus assets are to be distributed to the shareholders in the same priority as outlined in article 5 above. Therefore the investors ensure that they receive any surplus amounts in priority to the other classes of shareholders. This article also provides that if the company is unable legally to distribute its surplus assets to shareholders, the company's shareholders should take such action as is necessary to put the company into voluntary liquidation. The effect of this will be that article 5 above will apply in any event, and the surplus assets must then be distributed in the order of priority identified in the article.

Article 6.3

The objective of paragraph (a) of this article is to protect the investors', and to ensure that they receive the correct proportion of the proceeds on an IPO. The parties should consider whether these provisions apply on an IPO or Qualifying IPO.

The wording in the first set of square brackets provides that, on an IPO, the company will issue the investors with sufficient ordinary shares to ensure that they receive the same amount of cash for their shares as they would have done if their shares had been sold in a private share sale. This is based on the assumption that the company's value was equal to the "pre new money value", meaning that the company is valued by multiplying the number of shares in

issue immediately after the IPO (but not including any shares issued in the IPO) by the subscription price per share in the IPO (including any premium).

The second alternative in paragraph (a) provides that the company will issue the investors with such number of ordinary shares as, if sold in the IPO, would be equal to the amount that the investors originally paid for their series A shares.

Which of the two alternatives is included will be a matter for negotiation between the parties. The first alternative may give the investors a better return on their initial investment in the company, while the second alternative ensures that the investors receive the amount that they originally invested and paid for their shares.

The ordinary shares issued under this article are to be paid up by the automatic capitalisation of amounts standing to the credit of the company's share premium account and from other available reserves and are to be issued credited as fully paid. In the event that there are insufficient reserves to allow this, the investors can subscribe for those shares in cash (see *article 6.3(b)*). If the company needs to increase its share capital in order to issue these shares, the directors must ensure that this is done. This will usually require an ordinary resolution, passed at a general meeting or a written resolution signed by all of the shareholders.

The final paragraph of this article provides that the investors will also be issued with that number of ordinary shares as equates to the dividends accrued and/or in arrears on the series A shares.

Article 6.4

The purpose of this article is to ensure that where the board have approved an exit, it progresses as smoothly and swiftly as possible. Where the board have approved a share or asset sale, the shareholders waive any ability that they have to object to the exit, and agree to take all action necessary to facilitate such an exit. If any shareholder fails to take the necessary action, the article appoints the company as its agent, with authority to do anything necessary to complete the exit.

Article 6.5

At the outset, the parties should consider whether the series A shares should be redeemable in certain circumstances. If so, the relevant wording should be inserted in this section of the articles. (*See Appendix B below.*) However due to changes in the accounting treatment for redeemable shares (under Financial Reporting Standard 25), in certain circumstances the redemption amount will have to be shown as a financial liability on the company's balance sheet and therefore the company may resist including redemption provisions.

Article 7: Votes in general meeting

This article sets out details of the votes attaching to the different classes of shares.

Article 7.1

This article provides that holders of series A shares have the right to receive notice of, attend, speak and vote at general meetings of the company and to receive and vote on proposed written resolutions of the company.

Article 7.2

This article provides that the holders of ordinary shares also have the right to receive notice of, attend, speak and vote at general meetings of the company and to receive and vote on proposed written resolutions of the company.

Article 7.3

This article provides that the holders of any deferred shares do not have any rights to receive notice of, attend, speak or vote at general meetings of the company, nor any rights to receive or vote on proposed written resolutions of the company.

Article 7.4

This article provides that a proxy (for an individual or a corporation) has the right to vote on a show of hands (in accordance with section 284 of the Act). Proxies are covered in further detail in article 25 below.

Article 8: Vesting of ordinary shares

If a company makes special arrangements for shares to be held by its employees or founders, this will not usually create a separate class of shares. Under the BVCA model articles, the founders and employees hold ordinary shares, but they are subject to added conditions that apply to them as members of a scheme rather than holders of the particular share. The purpose of article 8, is to impose conditions on the shares held by the founders (and their permitted transferees), and to encourage the founders to remain in employment with the for such period as the investors consider is necessary to develop the business to a point where the founders involvement is no longer needed.

Careful consideration should be given when including provisions such as these in the articles. Although the investors may regard them as a way of encouraging the founders and key employees to remain with the company, the founders and key employees may regard the provisions as being restrictive. This will be a matter for negotiation among the parties and should be considered alongside any good and bad leaver provisions and any share option schemes or other incentives to be provided to the founders and employees. Consideration should also be given as to whether these provisions should apply only to founders (as is the case in the BVCA model articles) or whether they should also apply to shares held by key managers and employees.

Although the shares held by founders and employees are ordinary shares, consideration should be given as to whether they may fall into a separate class for some purposes (for example, sanctioning a scheme of arrangement in accordance with part 26 of the Act).

Article 8.1

This article is subject to article 8.2 if it is included (*see below*). It provides that if a founder ceases to be employed by the company within a 48 month period from the date on which that employment started (**Relevant Period**), a proportion of his or her ordinary shares (and shares held by their permitted transferees) in the company immediately convert into deferred shares which have no right to vote, minimal rights to capital and no right to receive a dividend. The percentage is calculated by reference to a formula (*see Leaver's Percentage above*) which is on a sliding scale, the net effect of which is that the longer the founder has been employed, the fewer shares that convert in deferred shares, such that at the end of month 48, none of the ordinary shares held by a founder would convert in this manner.

This article also includes optional wording in square brackets, which, if included, means that if the founder ceases to be employed by the company within 12 months of the date on which the shares held by that founder (or a permitted transferee) were issued, all of the shares which he or (they) holds will automatically convert into deferred shares.

Careful consideration should be given to the periods over which the ordinary shares vest with the founders. This will be a matter for negotiation between the parties at the outset of any investment. Also consider whether there are other milestones that should be tied to the vesting of these shares.

Article 8.2

This article is optional. It introduces a concept of "accelerated vesting" so that if a founder leaves during the relevant period, due to illness resulting in incapacity or death, that founder's ordinary shares become fully vested. There is also the option to extend this so that it also applies if the founder is wrongfully dismissed.

Founders may also argue that if the company achieves an exit at a pre-defined value prior to the expiry of the relevant period, this should accelerate the vesting of all the shares held by the founders so that they become fully vested.

Article 9: Conversion of series A shares

The provisions of this article enable the investors' series A shares to be converted into ordinary shares in certain circumstances. Generally, provisions such as this are included in the articles to assist the company's administration as they are likely to simplify matters on a sale or flotation of the company (*see article 6 above and article 9.2 below*).

Article 9.1

This article enables the investors to convert their series A shares into ordinary shares at any time by delivering a notice to the company.

Article 9.2 and article 9.4

Article 9.2 provides that the series A shares will automatically convert into ordinary shares on the date of any qualifying IPO. As drafted the articles include provisions relating to qualifying and non-qualifying IPOs (*see definitions above*). This means that the series A shares will only convert automatically if the IPO achieves a certain return for the investors (*see Qualifying IPO, above*), the parties should consider whether this is acceptable, whether the series A shares should automatically convert on any IPOs and/or whether to distinguish between qualifying and non-qualifying IPOs. These will be matters for negotiation between the parties.

Article 9.4 provides that the automatic conversion on a qualifying IPO shall take place only immediately before the IPO itself takes place, and for the purposes of this article that date is to be regarded as the conversion date. If for any reason the IPO does not take place, the conversion of the series A shares into ordinary shares will be deemed not to have taken place.

Article 9.3

This article relates to the mechanics of the conversions under articles 9.1 and 9.2, providing that the share certificates (or, if applicable, indemnities in respect of lost share certificates) should be delivered by the relevant shareholder to the company at its registered office at least five business days before an IPO or five business days following the date of the conversion notice given under article 9.1. This is an administrative issue for the company and will enable it to cancel the share certificates relating to the relevant series A shares and issue new share certificates for the appropriate number of ordinary shares to the investors.

Article 9.5 and article 9.6

These articles set out further mechanics relating to the conversion. Article 9.5 provides that on the relevant conversion date (namely the date of the IPO or the date that the investor sends the company the notice referred to in article 9.1), no further authority is required for the company to issue the ordinary shares, and the series A shares are converted into ordinary shares on the basis of one ordinary share for each series A share. The ordinary shares arising out of this conversion will rank equally with the company's other ordinary shares. The parties should consider whether a share for share exchange is appropriate or whether each series A share should convert into a higher (or lower) number of ordinary shares.

The purpose of article 9.5 is to make it clear that no shareholder or board approvals are required in order to convert the series A shares into ordinary shares. Ordinarily any form of re-designation of share capital such as this would require both board and shareholder approval.

Article 9.6 provides that on the relevant conversion date the company will:

- issue the appropriate number of ordinary shares to the holder of the series A shares;
- enter them in the company's register of members as the holder of those shares; and
- (subject to the delivery of share certificates or indemnities in compliance with article 9.3) within 10 business days of the relevant conversion date send to each converting series A shareholder new share certificates representing the ordinary shares.

Article 9.7

This article is primarily for the investors' benefit, and it is a mechanic by which any accrued or arrears of dividends on the series A shares are paid to the holder of those shares following their conversion into ordinary shares. Following conversion, if the company has profits available for distribution, it is obliged to pay all arrears and accruals of dividends on the shares that have been converted in accordance with this article, these amounts accrue up to the date immediately before the series A shares are converted into ordinary shares. If the company cannot pay these amounts in full, it must make such payments as it is legally able to make.

Article 10: Anti dilution protection

The anti-dilution provisions protect an investor from dilution as a result of subsequent issues of shares at a price per share less than the price paid by the existing investor.

The principle here is that the dilutive effect resulting from any fall in the company's valuation should fall squarely on the shoulders of the non-investor shareholders.

Article 10.1

This article, known as the anti-dilution protection provision, is a mechanic for allaying one of the investors' biggest fears – that at some time after they have made their equity investment into the company, the company will issue further securities at less than the price paid by the original investors (commonly referred to as a "down round"). Whilst the anti-dilution protection provision is triggered by the issue of further securities at less than the price paid by the original investors, certain issues will not trigger the anti-dilution ratchet, such as shares issued pursuant to the exercise of an option granted pursuant to an employee option plan and other items set out in article 13.7 (*see below*).

The anti-dilution ratchet provides the original investors with protection against dilution by issuing bonus shares to them (**anti-dilution shares**). The anti-dilution shares may be either series A shares or ordinary shares, this will be a matter for negotiation among the parties.

The number of shares that the original investors will receive depends on whether they have "full ratchet", "narrow based weighted average ratchet" or "broad based weighted average ratchet" protection:

Full Ratchet. This effectively rebases the original investor's starting price per share to that of the new down round price; in simple terms what number of shares would the original investor have received had it bought shares at the down round price?

Narrow-Based Weighted Average Ratchet. This reduces the price per share by averaging the price across the rounds and taking into account how many shares are actually sold at the down round price compared against the number of shares outstanding.

Broad-Based Weighted Average. This type of ratchet reduces the price per share by averaging the price across the rounds and taking into account how many shares are actually sold at the down round price compared with the share capital of the company on a fully diluted basis, that is the share capital of the company supporting all options, warrants and securities convertible into shares as if such options, warrants and securities had been converted) together with all issued shares.

Article 10.1 provides, in the alternative, for all three options. Which (if any) is included will be a matter for negotiation between the parties. As the worked examples below demonstrate, each type of ratchet produces very different results.

Worked Example:

Newco is a start up vehicle. Mr X and Miss Y are founders and in aggregate they own 9,000 ordinary shares of £1 each in Newco. Newco then raises £1,000 by way of a series A fundraising by issuing a total of 1,000 series A shares at £1 each, subscribed as to £750 by Investor X and £250 by Investor Y. Following the series A fundraising the share capital of Newco is as follows:

- *issued share capital of £10,000 made up of 9,000 ordinary shares of £1 and 1,000 series A shares of £1;*
- *no options;*
- *fully diluted share capital £10,000.*

Newco then grants options over 1,000 ordinary shares to its employees at an exercise price of £1, thereby increasing its fully diluted share capital to £11,000.

Twelve months later Newco decides it needs to raise additional money to fund its working capital requirements. The market is slow and the only interested party is Investor Z. Investor Z invests £1000 for series B shares at a price of £0.50 per share, giving it a holding of 2,000 series B shares. Following the series B fundraising, the share capital of Newco is as follows:

- *issued share capital of £11,000 made up of 9,000 ordinary shares of £1, 1,000 series A shares of £1 and 2,000 series B shares of £0.50;*
- *options over 1,000 ordinary shares;*
- *fully diluted share capital £12,000.*

The series B fundraising triggers the application of the anti-dilution protection provision for Investor X and Investor Y (a "Qualifying Issue"). The number of anti-dilution shares that they are entitled to receive will depend on the type of ratchet that is included in Newco's articles:

Full Ratchet

$$N = \left(\frac{W}{X} \right) - Z$$

Where:

- N = the number of Anti-Dilution Shares;
- W = the total amount subscribed by the relevant Investor for its series A shares;
- X = the price at which each new security, the series B shares, is to be issued, that is £0.50;
- Z = the number of series A shares held by the relevant Investor prior to the Qualifying Issue;

Result: Investor X is entitled to an additional 750 shares and Investor Y is entitled to an additional 250 shares

Narrow-Based Weighted Average Ratchet

$$N = \left(\frac{W}{WA} \right) - Z ;$$

Where:

- N = the number of Anti-Dilution Shares;
- W = the total amount subscribed by the relevant Investor;
- WA = the weighted average price per share held by Investor X and Investor Y as calculated by the following formula:

$$WA = \frac{(T + M)}{(B + Y)}$$

- T = the total amount subscribed by Investor X and Investor Y, that is £1,000;
- M = the aggregate of amounts to be paid in respect of the new series B shares issued pursuant to the Qualifying Issue, £1,000;
- B = the total number of series A shares subscribed by Investor X and Investor Y, that is 1,000;
- Y = the total number of new securities, the series B shares, to be issued, that is 2,000;
- Z = the number of series A shares subscribed by the relevant Investor.

Result: Investor X is entitled to an additional 375 shares and Investor Y is entitled to an additional 125 shares

Broad – Based Weighted Average Ratchet

$$\left(\left(\frac{SIP}{WA} \right)^{xZ} \right) - Z = N$$

Where:

N= Number of Anti-Dilution Shares

$$WA = \frac{(SIP \times ESC) + (QISP \times NS)}{(ESC + NS)}$$

SIP = Starting Price, that is the per share price paid by Investor X and Investor Y for series A shares, that is £1.00

ESC = the number of Equity Shares in issue plus the aggregate number of shares in respect of which options to subscribe have been granted, or which are subject to convertible securities (including but not limited to warrants) in each case immediately prior to the issue of the series B shares to Investor Z, 11,000.

QISP = the per share price of the series B shares issued pursuant to the Qualifying Issue, £0.50

NS = the number of series B shares issued pursuant to the Qualifying Issue, 2000

Z = the number of series A shares held by the relevant Investor

Result: Investor X is entitled to an additional 63 shares and Investor Y is entitled to an additional 20 shares

Article 10.2

This article deals with the mechanics for issuing the anti-dilution shares. Once the anti-dilution ratchet is triggered, this entitles the original investors to receive the anti-dilution shares. Under English company law, shares must be allotted for at least their nominal value. If the company has reserves in its share premium account, it can capitalise these and allot the anti-dilution shares to the investors without any payment by them (this amounts to a bonus issue of shares). If, at the relevant time, the company does not have sufficient share premium, the investors can opt to pay the nominal value for each anti-dilution share that they receive.

Article 10.3

This article gives the investors non-price based anti-dilution protection. So, for example, if the share capital is re-organised by way of a consolidation or sub-division of shares, the price that the original investors paid for their shares (the starting price used in the ratchet formulae) is adjusted accordingly.

Article 11: Deferred Shares

Deferred shares are effectively a device through which the company can achieve a reduction of capital. As noted in article 7.3 above, deferred shares do not carry any voting rights, and do not have any dividend rights. On a return of capital (*see article 5 above*) they rank after the series A shareholders but receive only £1 in aggregate.

Always consider whether deferred shares are necessary to the structure of the transaction. If the investment is very simple and does not include good/bad leaver provisions or a vesting schedule for founder and employees' shares, they may not be necessary.

Article 11.1

This article provides that the deferred shares may be redeemed by the company at any time for a penny for all of the deferred shares registered in the name of any holder. This should enable the company to tidy up its balance sheet without the need to go through the buy-in procedure or a formal reduction of share capital.

Article 11.2

If any deferred shares are created or issued, the company has irrevocable authority to appoint anyone to execute a valid transfer of those shares on behalf of the holder. This will, for example, enable the company to redeem those deferred shares in accordance with article 11.1 above, as it ensures that it has the authority to deal with the stock transfer form itself. More importantly, it will enable the company to transfer the deferred shares into the hands of an ally of the company. As the deferred shares are a separate class of share, they will have class rights under section 630 of the Act, and so the company may find that it needs to get class consent from the deferred shareholders to do various things. As the deferred shares will be held by founders who have had their employment with the company terminated, they may be hostile and deliberately use their class rights to veto such actions. The company can therefore use this irrevocable authority to transfer the shares to an ally.

Article 12: Variation of rights

Under the provisions of section 630 of the Act, the rights of any class of shares in the capital of the company may only be varied in accordance with the provisions of the articles as to variation of those rights or, in the absence of such provisions, either with the consent in writing of the holders of three-quarters in nominal value of the issued shares of that class or by a special resolution passed at a separate general meeting of the holders of the class. Article 12 seeks to vary the statutory provisions relating to class rights, in relation to the percentage of the class required to consent to such variation (article 12.1) and in the case of the series A share class, setting out exactly what constitutes a variation to be special rights attaching to the series A shares.

Note that there is some uncertainty as to whether the inclusion of provisions for the variation of class rights may constitute "entrenchment provisions" under sections 22 – 24 of the Act. Entrenchment provisions are provisions in the articles which have the effect of requiring conditions to be met or procedures complied with that are more restrictive than those applicable to a special resolution.

Section 22(2) has not yet been brought into force due to this uncertainty and concerns that it may unintentionally catch provisions in articles in connection with class rights, such as where the alteration of the articles is a deemed class right requiring specific consent which is more restrictive than the procedure required for a special resolution. Nonetheless, the remaining parts of section 22 and sections 23 and 24 of the Act came into force in October 2009.

As a result, if the provision for variation of class rights in the articles could constitute an entrenchment provision, then its inclusion or removal must be notified to Companies House and any changes to the articles must be accompanied by a statement of compliance when filed at Companies House.

Article 12.1

This article provides that the special rights attached to any class of share may be altered with the written consent of 75% of the shares in that class. There is no requirement to hold a class

meeting. The parties should consider whether 75% is an appropriate percentage to include in this article. In some circumstances, it may be appropriate to increase this percentage to 90% or even 95%.

This position is altered in relation to the series A shares, providing that they may be varied or altered with the investors' consent (*as defined above*). Again, whether this variation is appropriate will be a matter for negotiation among the parties. For example, if there is a syndicate of investors, and the investors' consent is defined as the consent of the lead investor of the syndicate, a provision such as this may not be acceptable to the other investors.

Article 12.2

This article sets out details of certain events that are deemed to vary the rights attaching to the series A shares (and therefore where the approval of the series A shareholders will be necessary). These events include: altering the articles of association, altering the issued share capital of the company (other than as provided for in the articles), reducing the amounts standing to the credit of the share premium and capital redemption reserves (unless it is in accordance with the articles) and making any bonus issue of shares or debentures. It also includes an increase to the maximum amount of shares that may be allotted – this can be deleted if articles 3.1 and 3.2 are deleted.

Article 12.3

Article 12.3 provides that the creation of a new class of shares with preferential rights to any of the existing class of share shall not alone constitute a variation to the existing classes of shares. However, such an issue of shares would probably alter the issued (if not the authorised) share capital of the company and so be likely to fall within the provisions in article 12.2(b) and it would also necessitate an amendment to the company's articles, so would fall within article 12.2(a) too.

Article 12.4

This article is for use where it is intended that shares not fully paid up should not have voting rights until those shares are fully paid.

Article 13: Allotment of new shares or other securities: pre-emption

If a company makes any future share offering, the investors will want the ability to maintain their percentage stake in the company by participating in the new offering in proportion to their existing holdings. They will also require that this participation is on the same terms and conditions as other participating investors. Pre-emption rights give existing shareholders a right of first refusal over issues of new shares, allowing them to preserve their percentage shareholding in the company (provided that they have sufficient funds available to subscribe for the new shares). Certain issues will usually be exempted from the pre-emption rights, including the issue of anti-dilution shares and the issue of shares on the exercise of share options (*see article 13.7, below*).

Article 13.1

The company's directors are only able to allot shares or grant rights to subscribe for or convert any security into shares if they are authorised to do so either by the company in general meeting or by the company's articles (*section 549(1), Act (formerly section 80(1) of the Companies Act 1985*)).

A valid authority given pursuant to section 551 of the Act must state the maximum amount of shares that may be allotted under it and the date on which it will expire. In the case of authority pursuant to section 551 of the Act included in the articles, this must not be more than five years from the date on which that authority was incorporated in the articles

(*section 551(3), Act*). Article 13.1 is drafted in accordance with the restrictions set out that section.

Article 13.2

The Act sets out detailed procedures with which a pre-emptive offer has to comply, including the form the offer should take and the length of time during which it may be accepted (*sections 567(1), 561(1) and 562(1)-(5), Act*). However, the application of these statutory pre-emption rights can be excluded, indefinitely, by a private company's articles of association (*section 567(1) and 570, Act*), or by special resolution (*section 571, Act*), in which case the disapplication must be limited to the length of the authority given pursuant to section 551 of the 2006 Act to which it relates (*see article 13.1 above*).

This article includes an appropriate disapplication of the statutory pre-emption rights, and as it is included in the articles the disapplication is for an indefinite period.

Article 13.3

This article provides that any new shares or securities convertible into shares in the company must be offered to the company's existing members first. Certain issues of securities will not trigger the pre-emption process and these issues are set out in article 13.7.

This article provides, in the alternative, that the shares should be offered in the first instance either to the series A shareholders or to all the company's holders of equity shares. It will be up to the parties to agree which is appropriate in the circumstances of a given transaction.

The offer must be on a pro rata basis to the relevant investment shareholding in the company and on the same terms as it is being made to third parties. It must also be made in writing and may indicate that if a shareholder wishes to subscribe for shares in excess of its pro-rata shareholding, it should state the additional number of shares for which it intends to subscribe.

Therefore, if the offer to subscribe for the shares is accepted by the relevant shareholders it will protect the percentage of shares that the shareholder has in the company. If excess shares are subscribed for, the existing shareholder's stake in the company may even increase (*see article 13.4, below*). In view of this, careful consideration should be given as to whether these provisions apply only, in the first instance to the series A shareholders, or whether they should also apply to the ordinary shareholders.

Article 13.4

This is a mechanical provision and provides that any shares that are not accepted by the relevant shareholder shall be used to satisfy any requests for additional shares made under to article 13.3. If there are insufficient shares to satisfy all of the requests for additional shares, the additional shares will be allotted to the applicants pro rata to the number of shares that the applicants held immediately before the offer was made to them. The additional wording at in square brackets at the end of the article provides that if there are still spare shares after the additional allotments have been made, the directors can offer those shares to anyone, as they think appropriate. These words should only be included if the shares are offered to all the shareholders and not just the holders of the series A shares. If this is not the case, they should be included at the end of article 13.5.

Article 13.5

This article should only be included if the original right of first offer is made only to the holders of series A shares. It provides that if, after offering them to the holders of series A shares, and taking into account any additional shares that are subscribed for pursuant to article 13.4, the board should offer the remaining shares to the holders of ordinary shares pro rata to their shareholdings. The ordinary shareholders have ten business days in which to indicate the

number of shares that they wish to subscribe for, and the shares will be allotted in the same manner as contemplated by articles 13.3 and 13.4 above. Note that the wording in square brackets at the end of article 13.4 should be included here.

Article 13.6

This article enables the board, subject to the right of first offer and to obtaining the necessary approvals from the investors, to grant options or otherwise dispose of new shares that are not subscribed for, in any manner and to any person that they think proper, subject to the approval of the Investor Majority.

Article 13.7

There are certain types of share issue to which pre-emption rights do not apply. Details are set out in this article, and they include:

- the grant of options under employee share option plans, the number of which has been approved by the investor in advance;
- shares issued in order to comply with the anti-dilution provisions of article 10;
- shares issued as special dividends or as a result of a qualifying IPO (*see articles 4.7 and 6.3, above*);
- shares issued as consideration for an acquisition by the company (or a member of the same fund group); and
- shares issued with the approval of a majority of the investors.

The parties should consider whether it is appropriate to include all the circumstances referred to in this article and whether any other issues of shares or securities should fall within this article.

Article 13.8

The tax treatment of shares allotted to employees, founders and directors is complex and is not covered by this drafting note. However, note that if shares acquired by reason of employment are restricted securities (for example, because of potential forced transfer at less than full market value), shareholders can elect under section 431 of Income Tax (Employment and Pensions) Act 2003 (**ITEPA**) to be subject to an income tax charge on the full unrestricted value of the shares at the time of acquisition. If they do, no further income tax charges will arise when the restrictions are lifted. If they do not, in addition to an up-front income tax charge on the difference between full market value of the restricted shares and the acquisition price, there may be a subsequent income tax charge. This article provides that before any shares are allotted to employees, founders and directors, they must enter into a joint election with the company under section 431 of ITEPA. The company's reason for requiring a section 431 election is that if the employees do not enter into an election, the income tax charge arising at the time of lifting of the restrictions may trigger an Employer NIC liability in the company, which will not be transferable to the employees. Had elections been entered into, an Employer NIC liability may either not have arisen at the time of allotment or would have been smaller.

Article 14: Transfers of shares: general

This article includes provisions relating to the transfer of shares generally. The provisions apply to all transfers of shares made under the articles including those that are permitted transfers (*see article 15, below*), transfers that are subject to pre-emption rights (*see article 16, below*), compulsory transfers (*see article 18 below*), compulsory transfer relating to employees

(see article 19, below), transfers as a result a change of control of the company (see article 20, below), transfers arising out of rights of co-sale (see article 21 below) and transfers arising as a result of drag along rights (see article 22 below).

Article 14.1

This article states that for the purposes of articles 14 to 22, a transfer includes a transfer or assignment of a beneficial interest in that share, the creation of a trust in relation to a share or the creation of any type of encumbrance over the shares.

Article 14.2

This article provides that no share can be transferred unless the transfer is made in accordance with the articles.

Article 14.3

This article includes a rather draconian provision, which states that if a shareholder attempts to transfer a share in a manner that is not in accordance with the articles, that shareholder will be deemed to have served a transfer notice in relation to all of the shares that he or she holds in the company. This means that the relevant shareholder will be forced to sell or transfer his or her shareholding in the company in accordance with the provisions of article 16. For a full explanation of these procedures, see article 16, below. Once a notice of this type is given, it cannot be withdrawn.

Article 14.4

This article includes a provision stating that any transfer that is by way of sale will be deemed to include a warranty that the transferor sells the share(s) with full title guarantee.

The effect of such a warranty is that certain covenants as to title to the shares are implied as a result of the provisions of the Law of Property (Miscellaneous Provisions) Act 1994. Selling with full title guarantee means the transferor of the shares warrants that:

- it has the right to dispose of the shares;
- it will do all that it reasonably can to give the buyer the title it purports to give, at its own cost;
- the shares are sold free of all charges, encumbrances and third party rights, other than those charges, encumbrances and rights which the seller does not and could not reasonably be expected to know about.

Article 14.5

This article relates to the ordinary shares held by the founders. The founders cannot transfer ordinary shares which are unvested and remain capable of conversion into deferred shares as a result of the provisions of article 8 (see above).

Article 14.6

This article sets out certain circumstances in which the directors have the right to refuse to register the transfer of a share. These include circumstances which were previously found in Regulation 24 of Table A, such as where the appropriate procedural requirements are not followed such as lodging the relevant documents at the appropriate place (usually the company's registered office), ensuring the transfer relates to only one class of shares and ensuring that the transfer is not in favour of more than four transferees.

Article 14.6 also gives the directors discretion to refuse to register a transfer if the transfer is to a bankrupt, a minor or a person of unsound mind or if it is a transfer to an employee, director or prospective employee or director who has not entered into a joint section 431 ITEPA election with the company (*see article 13.8, above*).

This article also allows directors to refuse to register transfers of shares not fully paid up to a person of whom the directors disapprove and shares over which the company has a lien.

The position under the Model Articles is much wider, giving the directors absolute discretion to refuse to register any transfer. This has been disapplied.

Article 14.7

This article provides the investors and other parties to the investment agreement with comfort as to how any new shareholders in the company will act. It enables the directors to impose a condition on registering any transferee of shares, meaning that the directors may refuse to register a transfer of shares if the transferee has not executed a deed of adherence to the investment agreement (or another similar document) whereby the transferee agrees to be bound by the terms of the investment agreement. It does not allow the directors to impose additional or more onerous obligations on the transferee than those that the transferor had. If the directors choose to impose this as a condition to registration of a transfer, the relevant transfer cannot be registered until the appropriate deed of adherence is delivered to the company's registered office.

This article may be invoked at the option of the directors. The parties should consider whether this should be a mandatory requirement for all transfers of shares in the company, or whether making it a mandatory requirement would create too onerous an administrative burden given the ability of the shareholders to make permitted transfers (*see article 16, below*).

Article 14.8

This article enables the directors to make appropriate investigations to ascertain whether there has been any transfer or disposal of shares. The investor directors can request the directors to use these powers or the directors may use them of their own volition. The article empowers them to make enquiries of any shareholder, personal representative of deceased members or any purported transferee of shares and request such persons to provide them with the information that the directors regard as being necessary to demonstrate the interest that the relevant shareholder has (or does not have) in the company's shares.

In the event that the directors don't receive the information, or if they do not receive sufficient information to enable them to determine whether there has been a breach of the articles or, if the directors conclude that there has been a breach of the articles, they are obliged to notify the relevant holder in writing of that fact. When the directors make this notification, the shares in question cease to have any voting rights (unless the effect would be to make the company a subsidiary of one of the investors) and they also lose any rights to receive dividends (which accrue after the date of the notice) unless they are series A shares with the right to a preferred dividend.

In addition, in such circumstances the directors can also send a written notice to the holder of those shares requiring the shareholder to transfer them to such person and at such price as the directors regard as appropriate. The voting and dividend rights may be reinstated by the board (provided that it has the appropriate investor consent) or on completion of any transfer that the directors regard as appropriate.

Article 14.9

This article addresses the circumstances where a transfer notice should be given, but the relevant shareholder fails to do so within ten business days. In such circumstances a transfer

notice is deemed to be given. Any transfer notice given or deemed to be given should be regarded as having set out the price for the shares (which if not agreed between the board and the selling shareholder will be the fair value of those shares determined in accordance with article 17.3 (*see below*)). It will also assume that there is no minimum transfer condition and that the seller wishes to transfer its entire holding of shares in the company.

Article 14.10

This article requires that where shares being transferred are not fully paid the transferee must sign the stock transfer form as well as the transferor in acknowledgement of the unpaid capital.

Article 15: Permitted transfers

This article relates to shares held both by the investors and the founders. Both the investors and the founders will be keen to ensure that they are able to transfer the shares that they hold in the company. In the case of the investors this is likely to be to other group companies and members of the same fund group. In the case of the founders a provision such as this will be beneficial for tax planning purposes, and they are likely to require the ability to transfer their shares to close family members and family trusts. How wide these permitted transfer provisions are will be a matter for negotiation between the parties.

Article 15.1

This article allows shareholders to transfer shares in the company to their permitted transferees, with such transfers being unrestricted. Note that in so far as the founders are concerned, this article is subject to article 14.5 above, so that the founders can only transfer the ordinary shares with the consent of the Investor Majority.

Article 15.2

This article permits the legal representative of a deceased shareholder to transfer shares to permitted transferees of the deceased shareholder. Any shares that have been transferred in this manner can then be transferred to other permitted transferees of the original shareholder.

Article 15.3

This article deals with the position where the permitted transferee ceases to be a member of the same group of companies. In such circumstances, any shares that have been transferred to the relevant company must be transferred back to either the original shareholder or to a member of the same group, within five business days of ceasing to be a member of the same group of companies. Failure to carry out this transfer will result in the permitted transferee being deemed to have given a transfer notice in respect of the shares, in which case the provisions of article 16 below will apply.

An alternative approach may be to enable any of the company's directors to execute a transfer of such shares to the original shareholder, although this may not always have a desirable effect.

Article 15.4

This article deals with the position where a permitted transferee ceases to be part of the same investor group. In such circumstances, that permitted transferee must transfer the shares to either the original shareholder or another permitted transferee, failing which it will be deemed to give a transfer notice in respect of those shares.

Note that the definition of "investor group" for the purposes of the definition of Permitted Transferee will vary from transaction to transaction, and will be a matter for negotiation between the parties: it may be restrictively drawn up to cover only those investors involved in

the first round of funding, or may be wider, including other named (or unnamed) venture capitalists and institutional investors.

Article 15.5 to article 15.7

These articles deal with permitted transfers to family trusts and by trustees of such trusts. Before a permitted transfer is made to a trustee, the board must be satisfied with the terms of the trust, the identity of the trustees and that the company will not be responsible for any costs in establishing or the administration of family trusts (which are likely to be for the benefit of the founders). The board must also be satisfied that such a transfer will not result in more than 50% of the company's share capital being held by trustees generally.

In turn, the trustees are permitted to transfer shares to a company wholly owned and controlled by them, to the original shareholder or another of the original shareholders' permitted transferees or to the new or remaining trustees of a family trust when there is a change of trustees.

Where the trustees transfer shares to a company wholly owned and controlled by them, if that company changes control, that company must either transfer the shares back to the trustees or to another company wholly owned and controlled by the trustees.

Article 15.8

The definition of permitted transfer allows the shareholders (particularly the founders and other individuals) to transfer their shares to close family members, exactly how widely transfers such as this are permitted will vary from transaction to transaction.

This article addresses the position where shares have been transferred in this manner, and the relevant transferee ceases to be the spouse or civil partner of a relevant shareholder as a result of divorce or otherwise. In such circumstances, within 15 business days, the shares in question must either be transferred back to the original shareholder or to another permitted transferee of the original shareholder for such consideration as is agreed or a transfer notice must be given in respect of the shares, meaning that they will be offered to other shareholders in accordance with the provisions of article 16 below.

Article 15.9

This article deals with what happens on the death or an insolvency event of any permitted transferee. The relevant personal representative, liquidator, administrator or administrative receiver has five business days in which to execute a transfer of the shares. This must be to either the original shareholder (if living and not subject to any insolvency arrangements), or may be to such other permitted transferee of the original shareholder as that original shareholder directs. If the transfer is not effected within five business days or if the original shareholder is dead or the subject of insolvency proceedings, the personal representative or appropriate insolvency practitioner will be deemed to have served a transfer notice in respect of the shares, meaning that they will be offered to other shareholders in accordance with the provisions of article 16 below.

Article 15.10

This article provides further flexibility, and permits any transfer of shares to be unrestricted, provided that it has been approved by the investor majority.

Article 15.11

This article allows the transfer of shares where there is a sale of the entire issued share capital of the company to a holding company of the company approved by the board including investor director consent. This may be required prior to an IPO.

Article 16: Transfers of shares subject to pre-emption rights

These articles set out provisions whereby existing shareholders must offer any shares that they want to transfer or sell to existing shareholders, before they can be sold or transferred to a third party.

Article 16.1

This article provides that unless a transfer is a permitted transfer, a mandatory offer arising as a result of change of control, a transfer with a right of co sale or a transfer as a result of drag along provisions (*see article 15, above, and article 20 to article 22 below*), it will be subject to the pre-emption rights set out in this article.

However, the articles referred to above should always be read carefully, as the provisions of article 16 may continue to apply to some transfers made under them. For example, there are certain circumstances in which transfer notices are deemed to be given under the permitted transfer provisions set out in article 15, in which case, the provisions of this article will apply following the deemed service of the notice.

Consideration should be given as to how the pre-emption provisions apply. For example, should the shares be offered to all shareholders pro rata to their shareholdings, or, as in the BVCA model articles, to a particular class of shareholder in priority to other classes? This will be a matter for negotiation between the parties.

In addition, where pre-emption provisions are included, ensure that the articles include provisions such as those contained in article 17 for valuing the shares.

Article 16.2

This article sets out the information that transfer notices (and deemed transfer notices, unless the articles specify otherwise) should contain. They must include:

- details of the number of shares to be sold or transferred (**sale shares**);
- the name of the third party that the shareholder proposes to sell the shares to;
- the price (in cash) at which the shares are to be transferred (**transfer price**);
- details of whether the transfer notice is conditional on all or a specific number of the shares included in it being sold (**minimum transfer condition**).

Article 16.3

This article provides that once a shareholder has given a transfer notice, it cannot be withdrawn other than with the prior written consent of the investor directors or the Investor Majority.

Article 16.4

This article provides that the effect of a transfer notice is to appoint the company as the selling shareholder's agent for the sale of the sale shares at the relevant transfer price. This means that the company will be able to take all actions needed, and is particularly important in circumstances where a transfer notice has been deemed to be given as a result of the relevant selling shareholder failing to take some form of action.

Article 16.5

This article requires that the board should offer the sale shares to the relevant shareholders as soon as practicable following receipt of a transfer notice. If that notice does not include details of the transfer price, they must be offered as soon as the transfer price is determined in accordance with article 17 (*see below*). In the case of deemed transfer notices the transfer price will also be calculated in accordance with article 17.

Article 16.6

This article sets out the priority in which the sale shares should be offered to existing shareholders.

If the sale shares are series A shares, they should be offered to other series A shareholder first and to ordinary shareholder who have converted their series A shares to ordinary shares and then to the other ordinary shareholders.

If the sale shares are ordinary shares, they should be offered to an employee trust, then to ordinary shareholders (as if they constituted a single class) and thirdly to holders of series A shares.

Consider whether this basis of offering shares is appropriate to each transaction. For example, there may be no employee trust to offer shares to or, it may be appropriate for any shares to be offered to all shareholders pro rata to their existing shareholding.

Article 16.7: first offer

This sets out the mechanics of how the first offer should be made to shareholders. It provides that it should be made in the priority referred to in article 16.6 above. Once the offer is made to the relevant shareholders, they have 15 business days in which to apply in writing, stating the maximum number of shares that they wish to purchase. If there is a minimum transfer condition, any allocation of shares will be dependant on this number of shares being purchased.

At the end of the first offer period, if the number of sale shares applied for by the continuing shareholders exceeds the number of sale shares, the board will allocate the shares to the continuing shareholders in the proportions that their shares bear to the shares held by all the shareholders accepting the company's offer. However, a shareholder will not be required to purchase more shares than the maximum that it has indicated it is willing to buy.

If this results in some of the sale shares not being allocated, but there are other applications that have not been satisfied, then the sale shares shall be allocated to those other applicants on the same, proportionate, basis.

If the number of shares applied for is less than the number of sale shares available, they will be allotted in accordance with the actual applications and the surplus sale shares will be dealt with in accordance with article 16.8 below.

Article 16.8

This article sets out the details of the second offer. These provisions will apply only when there are surplus sale shares following the first offer. The surplus sale shares are to be offered to all the continuing shareholders in the company. Aside from the fact that no reference is made to the priority in which the shares are to be offered, the other mechanical provisions are the same as the first offer. If any shares have not been purchased following this second offer, they may be sold to any third party in accordance with article 16.9 (*see below*).

Article 16.9

This article includes further mechanics for completing the transfer of shares.

If the minimum transfer condition is not met, the company must inform the selling shareholder and any shareholders who applied for sale shares that this condition has not been satisfied and that the transfer notice has therefore lapsed.

If there is no minimum transfer condition, and allocations have been received in respect of all of the sale shares, the board should give written notice of the relevant allocations to the seller and each of the shareholders that have applied for shares. The notice to each of the shareholders should include details of his allocation of sale shares and a date for completion. When the seller receives the allocation notice, it must, against payment of the transfer price, transfer the sale shares to the relevant shareholders. If the selling shareholder fails to execute the relevant transfers, the chairman or any of the company's directors is authorised to do so, and they are also authorised to give a valid receipt for the transfer monies and, subject to the stock transfer forms being stamped, to enter the relevant details of the purchasers of the sale shares in the company's register of members. The company is also obliged to open a separate bank account on trust for the seller, and to pay all amounts received in respect of the transfer price into that bank account. There is no requirement for this to be an interest bearing bank account.

If the minimum transfer condition has been satisfied, but the allocation notice does not relate to all the sale shares, the selling shareholder may, within eight weeks sell the remaining sale shares to any person provided that those shares are sold at a price at least equal to the transfer price. This right does not apply if the transfer is to one of the company's competitors, the sale is not bona fide or if the selling shareholder refuses to supply information to the board for the purposes of determining whether the sale is to a competitor and/or bona fide.

Article 16.10

This article enables the pre-emption provisions on transfer to be waived. This may be done with either the investors' consent or with the consent of shareholders who, but for the waiver, would have been entitled to buy some of the shares. The parties should consider whose consent is required.

Article 17: Valuation of shares

This article sets out detailed mechanics as to how the shares are to be valued in the event that the transfer notice does not include a price for the shares. This is important, particularly where a transfer notice is deemed to have been given, for example through a shareholder's default.

Article 18: Compulsory transfers: general

The investors will be keen to ensure that the company's shares are held by a reasonably small group of people (*see article 16: Permitted transfers, above*), as a result, certain events are likely to result in a mandatory transfer of shares, and the shareholder being deemed to have issued a transfer notice in accordance with the provisions of article 16 above. This article sets out details of these transfers.

Article 18.1 and article 18.3

Any person who becomes entitled to the company's shares as a result of the bankruptcy of an individual shareholder will be deemed to have given a transfer notice in respect of the shares at such time as the directors deem appropriate. Article 18.3 includes corresponding provisions for corporate shareholders who become insolvent and appoint or resolve to appoint a liquidator, administrator or administrative receiver.

Article 18.2

This article deals with the circumstances where the original shareholder has died, but the company's shares remain registered in that person's name for more than a year following the shareholder's death. In these circumstances, the directors can require the personal representatives to make a permitted transfer in accordance with article 15 above or to demonstrate to them that a permitted transfer will be made when the administration of the deceased's estate is complete. If the personal representatives fail to do this, a transfer notice will be deemed to have been given in respect of the relevant shares.

Article 18.4

This article is relevant where there is a change of control of a corporate shareholder (other than an investment fund). (*See Change of Control, article 2, above*). If there is a change of control of such an entity, the shareholding company is bound (if and when required by the company's directors) to issue a transfer notice in accordance with the provisions of article 16 in respect of the shares that it holds. If the company to whom the change of control occurs is a permitted transferee, it is allowed to transfer the shares back to the original shareholder or to another permitted shareholder of the original shareholder before it is required to serve a transfer notice.

Consider whether a transfer notice should be deemed to be served in circumstances where the company's directors require a transfer notice to be issued by the shareholding company under article 18.4, but the shareholding company fails to take the necessary action.

Article 19: Compulsory transfers: employees

Articles used in venture capital transactions often include provisions whereby if a founder, executive director or employee ceases to be employed by the investee company then he or she shall be deemed to have served a transfer notice in respect of those shares that he or she holds in the company (*see article 16, above*). The principle is that if a founder, executive or employee ceases to have an employment relationship with the company, they should cease to have any equity interest in the company.

There are several variations on this theme, for example the founders and employees may be entitled to retain an increasing number of their shares as time elapses from the date of the original investment. Additionally, compulsory transfer may be excluded if the founder or employee's appointment with the company ends as result of wrongful dismissal or due to ill health, or death. These are typically called good leaver and bad leaver provisions (*see Good Leaver and Bad Leaver, article 2, above*).

Article 19.1

This article is widely drafted and provides (in the alternative) that if any founder or employee ceases for any reason to be an employee (being a person in the employment of or who provides consultancy services to, the company or any member of its group), he or she shall be deemed to have given a transfer notice in respect of the shares held on the effective termination date.

For these purposes, the effective termination date is the earlier of:

- the date on which the employment or consultancy terminates following the expiry of any applicable notice period; or
- the date that the company and the employee or founder agree.

If the wording in square brackets is included (“prior to the end of the relevant period”), this clause will only apply where there is a termination of employment which is within 48 months of the employee’s commencement date.

The price at which the founder or employee is deemed to transfer his or her shares will depend upon whether he or she is a good leaver or a bad leaver. The shares held by the relevant founder or employee shall be deemed to be transferred at:

- the lower of fair value and the nominal value of the shares that are the subject of the transfer notice if the founder or employee is a bad leaver; or
- the fair value if the founder or employee is a good leaver.

The effect of these provisions is that where a founder or employee is a bad leaver, they will be deprived of any uplift in the market or fair value of the shares.

Given that founders are already penalised for ceasing to be employed by the company under article 8 pursuant to which some of their shares get converted into deferred shares, one needs to consider whether the additional compulsory transfer provisions here in respect of the shares that have vested is too great a penalty.

Article 19.2

The shares included in a transfer notice deemed to be given under this article must be offered in the following order of priority (rather than the priority set out in article 16.6 above):

- to a person or persons as agreed with the investor majority (*for definition, see article 1, above*) to take the departing shareholder’s place conditionally on them commencing employment with the company; and/or
- to any of the existing employees (other than the departing founder); and/or
- to other participants or potential participants in, or trustees of the Employee Share Option Plan (other than the departing founder); and/or
- to any other person or persons approved by the investor director and by the board; and/or
- to the company (subject to the provisions of the Act).

Note that although the provisions of article 19 impose a mandatory obligation on the founders and employees to issue a transfer notice in the circumstances outlined in the article, they do not impose a mandatory obligation on the other shareholders or those persons listed in article 19.2 to purchase the shares.

Article 19.3

Any voting rights attaching to the employee shares held by a founder are suspended immediately on the founder ceasing to be employed by the company. For these purposes, the employee shares include the shares held by the founder or those held by a permitted transferee of the founder (other than those shares that the investor majority are satisfied were not acquired directly or indirectly from the founder or by reason of the person’s relationship with the founder).

Article 19.4

The holders of shares with restricted voting rights are entitled to receive notice of and to attend general meetings of the company, but have no right to vote either in person or by proxy or to vote on any proposed written resolution. The voting rights suspended by this article are automatically restored in certain circumstances:

- immediately prior to an initial public offer of the company's securities; and/or
- if the restricted shares are transferred in accordance with the other provisions of the articles.

The investors should consider whether other provisions should be included in the articles. The investors may argue that not only are they investing in the business, but also in the company's management who should not be free to walk away prior to the investor exiting. So, for example, the investors may insist that the founders and key management are prevented from selling (or transferring) any of their shares for an initial period.

Article 20: Mandatory offer on a change of control

If a transfer of shares would result in a purchaser acquiring a controlling interest in the company, it is common (as in the BVCA model articles) to include a provision providing that the proposed seller must procure that the proposed purchaser extends the offer to purchase the shares of all other shareholders at the specified price (*see below*).

For the purposes of the articles, controlling interest is defined as an interest in shares giving the holder or holders control of the company within the meaning of section 1124 of the Corporation Tax Act 2010. Other alternatives for a definition of controlling interest include holding 51% or more of the equity share capital of the company, or where a person or persons acting together hold 30% or more of the company's equity share capital. The share structure of the company is likely to dictate which is the most appropriate. For example, if the founders and managers hold more than 30% but less than 50% of the company's equity share capital then controlling interest is likely to be 30%.

Article 20.1

The BVCA model articles provides that the provisions of this article are subject to the permitted transfers allowed under the articles (*see article 15, above*), any compulsory transfers made pursuant to articles 18 and 19 above and the pre-emption arrangements so that the shares are offered round to existing shareholders before they are sold to a third party in accordance with article 20.2 (*see article 16, above*). The provisions of this article apply if they would result in the third party (or those acting together with the third party) (**Proposed Purchaser**) acquiring a controlling interest in the company.

Article 20.2

Before the selling shareholders make a transfer to a Proposed Purchaser they are obliged to procure that the Proposed Purchaser extends its offer to the company's other shareholders to acquire all of the company's equity share capital (this excludes the deferred shares) for a consideration per share which is at least equal to the price specified in article 20.7 below.

Article 20.3

This article sets out the mechanics by which the Proposed Purchaser must make the offer. It must be made in writing, be made at least 10 days before the proposed sale date, include the identity of the Proposed Purchaser, the purchase price for the shares and any terms and conditions relating to the payment of the purchase price and the number of shares that the Proposed Purchaser intends to buy.

Article 20.4

This article gives the company's shareholders protection by ensuring that if a selling shareholder fails to comply with the provisions of this article, it is not permitted to complete the sale of the shares and the company will refuse to register any purported transfer of them in the Proposed Purchaser's name.

Article 20.5 and article 20.6

If any shareholder accepts the offer made by the Proposed Purchaser, the completion of the proposed transfer is conditional on the purchaser buying all of the shares held by shareholders that accept the offer. In such circumstances, the pre-emption provisions of article 16 do not apply to the purchase of shares from shareholders that accept the offer.

Article 20.7

This article sets out further mechanics and interpretation provisions that apply only to this article, it also includes details of how the purchase price for the shares are to be calculated.

Consider whether mechanics should be included to appoint an independent expert to resolve any disputes as to the price to be offered by the third party.

Article 21: Co-sale right

This article sets out a mechanism to ensure that if one founder (or employee) has an opportunity to sell some other shares, the other shareholders are also given that opportunity on a proportional basis. It is sometimes referred to as a "tag along" right.

The parties should consider whether this right relates only to founder and/or employee shares (the basis on which the BVCA model articles are drafted), or whether it should extend to the investors' shares (*see article 21.1, below*). Also consider whether including rights such as these will make the shares more difficult to sell.

Article 21.1

In the event that either a founder or employee wishes to transfer a certain percentage of his shareholding in the company other than by way of a permitted transfer, this article provides the company's other equity shareholders with a right to sell a proportion of their shareholding in the company too.

Note that the provisions apply in the alternative when either a founder or other employee sells the relevant percentage of their shareholding in the company. Consider whether these provisions should apply to a sale of the relevant percentage of shares made by any shareholder.

Note also that as drafted, provided that the appropriate percentage is to be sold, the provisions of this article apply to **all** transfers made by founders (or employees) unless they are made in accordance with the permitted transfer regime referred to in article 15. However, the mandatory pre-emption provisions set out in article 16 do not apply (*see article 21.6, below*).

Article 21.2

This article sets out the mechanics by which the selling founder (or employee) should inform the other equity shareholders of its proposed sale or transfer of shares.

Not less than fifteen days before the proposed sale or transfer is to take place, the selling founder (or employee) must send a notice to each of the company's other shareholders (other than deferred shareholders) ("**Co-Sale Notice**"), setting out details of the proposed purchaser,

the price per share that the buyer is willing to pay (with the proviso that in the case of the Series A Shares the price per share must not be less than the preference amount), the manner in which the consideration is to be paid and the number of shares that the selling founder (or employee) proposes to sell.

Article 21.3

The shareholders that receive the co-sale notice have five business days from its receipt in which to notify the selling founder (or employee) that they want to sell a proportion of their shares at the proposed sale price. This must be done by sending a counter notice to the selling founder (or employee) specifying the number of shares that the relevant shareholder wants to sell. If no counter notice is served within this time period, the other shareholders will be deemed to have indicated that they do not want to sell any shares.

The maximum number of shares that any shareholder can sell is restricted to a percentage of the shares being sold by the selling founder (or employee). So, for example, a shareholder wishing to exercise its rights under this article could not sell its entire shareholding or more shares than the selling founder (or employee).

Article 21.4

This article allows the selling founder (or employee) to sell its shares to the proposed buyer five business days after receipt of the co-sale notice by the company's other shareholder, but he can sell only the number of shares set out in that notice **less** the number of shares that other shareholders want to sell. This sale may take place only if the buyer (or another person) purchases shares from the other shareholders on terms no less favourable than those obtained by the selling founder (or employee).

Article 21.5

This article prevents a selling founder (or employee) from waiting for more than three months after issuing a co-sale notice before it sells its shares. After three months, another co-sale notice must be issued, thus giving the other shareholders a chance to assess the possible sale in the light of any changes in the company's circumstances.

Article 21.6

This article makes it clear that any sales conducted in accordance with this article are not subject to the pre-emption provisions set out in article 16 (*see above*).

Article 22: Drag-along

This article sets out a mechanism whereby if a specified percentage of shareholders agree to sell their shares, they can compel the other shareholders to sell their shares, ensuring that a prospective purchaser can acquire 100% of the company. These rights are sometimes referred to as "bring along" rights or obligations.

Consideration should be given as to whether these provisions extend to all of the company's equity shares or only to the series A shares. The BVCA model articles include both alternatives. In addition, careful consideration should be given to the percentages that trigger these obligations.

In early investment rounds, consideration should also be given as to whether these rights are absolute, or whether they can only be enforced with the consent of those holding at least a majority of the shares held by the investors. The investors may require that certain exceptions are included in the drag along provisions for situations where they cannot be obliged to sell their shares. For example, the investors will be keen to ensure that they receive cash or marketable securities for their shares, they are unlikely to agree to be brought along on a sale

where the consideration takes other forms of less realisable consideration such as shares in a private company or loan notes.

Article 22.1

This article sets out the basis on which the drag along rights will apply. It provides in the alternative for it to relate to a percentage of only the series A shares or of the entire equity share capital of the company.

Article 22.2

This article states that the drag along rights can only be exercised if the selling shareholders serve a drag along notice on the other non-selling shareholders (**called shareholders**) stating that the called shareholders are required to transfer all of their shares, the person to whom they are to be transferred, the price at which they are to be transferred and the date on which the transfer is to take place. Consider including provisions as to the timing of the notice.

Article 22.3

Once given, a drag along notice is irrevocable. However, a drag along notice will lapse if the selling shareholders haven't sold their shares to the proposed transferee within 40 business days of its service. A further drag along notice may be issued if the first one has lapsed.

Article 22.4

The called shareholders have to sell their shares for the amount that they would get if the total consideration were divided between all the sellers in accordance with the liquidation preference set out in article 5. The parties should consider whether this is appropriate, or whether the called shareholders should receive the same amount per share as the selling shareholders.

Article 22.6 to 22.8

Under these articles the called shareholders must deliver stock transfer forms and their share certificates (or an indemnity) within five business days of receiving a drag along notice. At the end of this period the company will, if it has been put in funds by the purchaser, pay the called shareholders the relevant amounts due under article 22.4 on behalf of the purchaser.

If the purchaser fails to put the company in funds by the end of the five business day period, the called shareholders can have their share certificates and stock transfer forms returned. This puts an onus on a purchaser to ensure that the company has the necessary funds to complete the transfer.

If the called shareholders fail to deliver stock transfer forms and their share certificates, any director of the company can transfer the shares on their behalf and only on receipt of their share certificates are they, entitled to be paid for their shares.

Article 22.9

The pre-emption provisions on transfers set out in article 16 do not apply to a transfer of shares under this article (*see article 16, above*).

Article 22.10

If any person becomes a shareholder on exercising an existing option to acquire shares in the company after a drag along notice has been served, an identical drag along notice is deemed to have been served in respect of the newly acquired shares and the provisions of article 22 then apply. However, rather than having five business days in which to complete the transfer

of the shares, the transfer must take place immediately on the drag along notice being deemed to be served.

Article 23: General meetings

In addition to their statutory power to convene general meetings of the company, directors are required under sections 303 and 304 of the Act to convene a general meeting of the company on the request of a member representing the required percentage in accordance with the Act. This article modifies the time within which the meeting must be held, providing that a meeting validly requested by a member must be held within 28 days of receipt of the request.

Article 23.2

This article provides that in the event that a shareholder meeting is adjourned due to lack of a quorum, the adjourned meeting will be quorate if there is at least one shareholder present holding a certain percentage in nominal value of all the shares or a particular class of share. This will often not be relevant in companies with several institutional investors, but may sometimes be helpful.

Article 23.3

This article deals with the determination of the location of the meeting if shareholders participate from different locations, namely the location specified in the notice or, if no one is at that location, the place where most participating shareholders are located or at the location of the chairman.

Article 23.4

This article clarifies that if a request for a poll is withdrawn, it does not invalidate the result of a vote on a show of hands already declared. This mirrors a similar provision in Table A which has not been included in the Model Articles.

Articles 23.5 to 23.7

The Model Articles provide that polls must always be held immediately. This article varies that position, allowing for polls to be held at a later date (within 14 days) if needed. Articles 23.6 and 23.7 are related provisions, dealing with notice of a poll held on a later date and delivery of proxies.

Article 24: Proxies

If a shareholder is unable to attend a general meeting of the company, it has the right to appoint a proxy to attend in its place. Table A included certain provisions regarding the form of proxy to be used and the validity of votes given by proxies. In addition, the Institute of Chartered Secretaries and Administrators (ICSA) issued a specimen form of proxy in January 2008 (which replaced an August 2004 version) which provides for votes to be withheld. This, coupled with the information which was required by Table A was regarded as best practice for companies. The Model Articles take a different, more flexible approach and do not specify the form of proxy notice. Nevertheless, it is expected that the previous best practice for proxies will continue.

The Model Articles also do not stipulate a time limit for lodging proxies, allowing this to be specified in the notice. The BVCA model articles expressly allow proxies to be deposited at any time before the relevant meeting is held (*see article 24*).

This article also provides for proxy appointments to be sent or supplied in electronic form. This corresponds to the provisions of article 32 (Notices) that allow notices to be sent by electronic means.

Article 25: Directors' borrowing powers

This article makes it clear that the directors have authority to use all the powers in the company's memorandum of association to borrow or raise money, create charges over its undertaking and property and to issue debentures or other securities for any debt or obligation of the company to a third party.

Article 26: Alternate directors

Unlike Table A, the Model Articles do not contain provision for alternate directors. This article contains provisions enabling the appointment of any person to act as an alternate director, which does not require the approval of the directors.

Under this article, the alternate can act as alternate for more than one director and has the same rights, in relation to a board meeting, as his appointor. The alternate may also count in the quorum and vote (if his appointor was eligible to vote).

Article 27: Number of directors

This article provides that, unless the company resolves otherwise, the company must have at least two directors. There is no maximum (nor does the BVCA model investment agreement state a maximum) but the parties may wish to consider including a maximum number in order to avoid having an unusually large board.

Article 28: Appointment of directors

In addition to the powers of appointment under article 17(1) of the Model Articles for the board and the shareholders by ordinary resolution, further provisions for the appointment of directors are set out in this article. These provisions, particularly those set out in article 28.1 and article 28.4 should be read in conjunction with clause 9.3 of the BVCA model investment agreement to ensure that they are consistent in their approach.

Under the Act, a director is required to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, rather than act as a representative of (and in the interests of) the person by whom he has been appointed. In order to avoid conflicts of interest for investor directors, venture capitalists often have an investment executive, other than the investor director, deal with the company when dealing with those matters that require investor consent (as opposed to investor director consent). (*See article 31, below regarding authorisation of conflicts of interest.*)

Some investors never exercise their right to appoint a director because of the potential conflicts of interest and liability issues. In such circumstances they commonly seek the right to appoint an observer to board meetings (*see article 28.4, below*). The observer will attend board meetings, but will not participate in any board decisions.

Article 28.1

This article allows each of the investors to appoint a director (**investor director**), (or, in the alternative, that the right to appoint a director is for so long as it and any of its permitted transferees hold a given percentage of the company's total issued share capital) and provides that the other shareholders cannot vote their shares to remove the investor's director from office. However, the investor may remove the director that they appoint and appoint someone else by giving written notice to the company.

Consider whether the investor should have an absolute right to appoint a director or whether it should be linked to the shareholding of the investor and its permitted transferees.

See also clause 9.3 of the BVCA model investment agreement and its accompanying explanatory notes.

Article 28.4

This article provides each investor with the right to appoint an observer to attend and speak, but not vote, at board meetings. Care should be taken by those appointed to act as observers as, depending on their level of involvement in the proceedings at board meetings and the management of the company, they may be regarded as either shadow or de facto directors of the company.

See also clause 9.3 of the BVCA model investment agreement and its accompanying explanatory notes.

Article 29: Disqualification of directors

This article supplements the provisions of article 18 of the Model Articles which relates to the disqualification and removal of directors. Accordingly, the circumstances in which the office of director must be vacated under this article (and article 18 of the Model Articles) include:

- ceasing to be a director by virtue of provisions of the Act;
- being prohibited by law from being a director;
- becoming bankrupt or makes any arrangement with creditors;
- physical or mental incapacity, in the opinions of a registered medical practitioner or by court order due to that person's mental health;
- resignation from the office;
- conviction of a criminal offence (other than a minor motoring offence);
- by his co-directors serving notice on him in writing, removing him. Note however that this provision does not apply to the investor directors who can only be removed by the appointing investor (*see article 28.1 above*).

Article 30: Proceedings of directors

These provisions supplement the provisions set out in articles 7 to 16 of the Model Articles. Articles 8(2), 9(4), 10(3), 11(2), 13 and 14 of the Model Articles are deleted (*see above*) and this article addresses some of the matters set out in those articles. These provisions should be read in conjunction with clause 9 of the BVCA model investment agreement and care should be taken to ensure that the provisions of that agreement and those set out in the BVCA model articles do not contradict each other.

Article 30.1

This article relates to the quorum requirements for board meetings. It requires that at least one investor director should be present. In the alternative, the article goes further, providing that the investor director appointed by a given investor (or all the investor directors) must be present in order to constitute a quorum. This additional wording is likely to be relevant where, for example, there is a syndicate of investors and the syndicate has a lead investor or where one investor holds a much larger percentage of the series A shares than the other investors. From the company's point of view, this additional wording is likely to be unpalatable as it may make convening and holding board meetings far more difficult if they have to be centred around the time commitments of a given investor director. In any event, whether this additional

wording is included is likely to be a matter for negotiation between the parties. Either requirement is subject to the proviso that if an interest of an investor director is being authorised by other directors in accordance with section 175(5)(a) of the Act and article 31, such investor director and any other interested director shall not be included for the purpose of such authorisation but the meeting shall be quorate.

If a quorum is not present within 30 minutes of the time appointed for the meeting, or if a quorum ceases to be present, the meeting stands adjourned until such time and place as the directors may determine. If there is no quorum at the adjourned meeting within half an hour of the time appointed for the meeting, the meeting may proceed as if it were quorate.

Article 30.2

This article provides that if the same alternate director is appointed by two or more directors the meeting may be regarded as being quorate even if the only person present is that alternate director.

Article 30.3

This article provides that if directors participating in board meetings are in different locations (for example, because they are participating by telephone), the meeting is treated as taking place where the largest number of them is located (failing which, where the chairman is located).

Article 30.4

This article provides that notice does not need to be given to a director who waives his right to notice. The waiver can be given at any time before or after the meeting. Directors cannot give a blanket waiver for all future meetings, as this would breach their general duties to the company.

Article 30.5

This article permits directors to vote on matters in which they are interested subject to any restrictions imposed under article 31, provided that the director's interest or potential conflict of interest has been declared in accordance with the articles.

Article 30.6

Decisions at board meetings are to be decided on a majority of votes. If the number of votes cast by directors is equal, the article provides two alternatives, either for the chairman to have a casting vote, or for the chairman to have no casting vote in the case. Which is appropriate in the circumstances of a given investment will be a matter of negotiation between the parties.

Article 30.7

This article allows the investor director to appoint a chairman of the board if a chairman has not been appointed within three months of the date of adoption of the articles or within three months of the chairman's resignation.

Article 30.8

This article confirms that directors' decisions can take the form of a written resolution, if all the directors sign a copy of it.

Article 31: Directors' Interests

Articles 31.1 and 31.2 provide a list of those interests in which a director, and specifically an investor director, can be interested without being in breach of his duty to avoid a situation in which he has a conflict of interest so long as the interest is duly declared to the board. Article 14 of the Model Articles has been disapplied and replaced by these more extensive provisions.

Articles 31.7 to 31.9 permit a director, whose conflict situation is authorised to take steps required by the terms of the authorisation, or which might otherwise be appropriate, to manage the impact of the actual or potential conflict of interest, so that those steps are not treated as amounting to a breach of duty.

This drafting note highlights the particular issues that arise in relation to investor directors. With regard to investor directors, it is not clear-cut how conflicts of interest should be dealt with from 1 October 2008. It is likely to take some time for a consensus to emerge among investor houses and their legal advisers.

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

There are three ways for conflicts to be authorised under the Act: (1) board resolution; (2) shareholder resolution; and (3) in the articles. These are considered in turn below. Note that merely hypothetical conflicts do not need to be addressed, as there is no breach of duty if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest.

1. Board resolution

This authorisation has a statutory basis and may be given by directors of a private company who are not themselves interested in the matter concerned, under section 175(5)(a) of the Act. A disadvantage is that there is no obligation on directors to give such authorisation or indeed to maintain it due to the fact that the directors' discretion cannot be fettered. The giving and maintaining of that authorisation will therefore not be directly in the hands of the venture capital house or the investor directors. However, once given, it is probably the most reliable form of authorisation in terms of its effectiveness, as the directors will have addressed their minds to the circumstances in question and it has a clear statutory basis.

Note that a private company incorporated before 1 October 2008 will need to have an ordinary resolution passed by its shareholders to apply the relevant provision of the Act before the directors are entitled to give such an authorisation. A copy of the resolution must be filed within 15 days with Companies House and a footnote must be inserted in the articles (*see below, article 31 footnote*).

2. Shareholder resolution

Section 180(4)(a) of the Act preserves the effect of any rule of law by which a company can authorise, in advance, acts or omissions of directors which would otherwise be a breach of duty. This effectively preserves the possibility of a shareholder authorisation with its basis in case law. The principle, which underpins this, is that a principal may provide informed consent for the acts of a fiduciary. The authorisation can only extend to matters within the proper contemplation of those giving it. An advantage of this authorisation is that it is in the power of a majority of shareholders to obtain or require it and any agreement to procure it does not need to be subject to fiduciary carve outs. In relation to other directorships in particular, it may however be difficult to argue that

particular conflicts of interest were in the contemplation of those passing the resolution, unless it is given in respect of particular circumstances when they become apparent.

3. In the articles

Section 232(4) of the Act provides an exclusion to the general prohibition in section 232(1) on including provisions exempting a director from liability. It states that nothing in section 232 prevents a company's articles from making "such provision as has previously been lawful for dealing with conflicts of interest". This does not however sit comfortably with section 180(4), which provides that the general duties (including therefore that under section 175) are not infringed by anything done (or omitted) by the directors, or any of them, in accordance with provisions in a company's articles for dealing with conflicts of interest. Unfortunately, it is unclear to what extent provisions such as this were permitted under the previous law, as the case law which predated the introduction of the Act provisions on conflict of interests were unclear and at times conflicting.

The uncertainty in the interpretation of the ambit and interaction of sections 232(4) and 180(4) of the Act leave space for the courts to develop the law in this area.

There is therefore a limit to what the articles can authorise in terms of conflicts of interest, but it is unclear what is that limit. These articles are therefore drafted on the basis that the directors may have an interest "save as to the extent not permitted by law from time to time", (however that law may be interpreted by the courts).

The interests permitted at article 31.1, are mostly an adaptation, with some expansion, of what was contained in regulation 85 of Table A immediately prior to 1 October 2008 and so should be broadly consistent with what was previously permitted. However, articles 31.1(c) and 31.2 go further:

- article 31.1(c) applies to duties a director may owe to, and interests directors might have in, undertakings in the extended group i.e. parent undertakings and sister undertakings;
- article 31.2 applies to investor directors and to the duties which the investor director could owe to, and to interests an investor director might have in, the fund manager and funds managed or advised by the fund manager and portfolio/investee companies.

The provisions in these two articles may therefore be open to question as case law develops, and it is, in particular, to take account of this that articles 31.1 and 31.2 are expressed to be "save as to the extent not permitted by law from time to time", so recognising the fact that these provisions might not be enforceable.

The potential conflicts of investor directors at the fund/ fund manager level are more likely to be within the contemplation of those concerned in a venture capital structure than duties to competing portfolio/investee companies. Conflicts relating to competing portfolio/investee companies seem to lend themselves to more specific approval and sit less well with the principle that there is a limit to what may be approved in the articles.

Whatever wording is included in a list of permitted situations in articles, as regards enforceability, it is advisable to keep it as narrow as possible.

Practical conclusions

It should generally be proposed to include authorisation in the articles for the possible conflicts of interest of an investor director in relation to his duties to and interests in the investor, fund manager, and portfolio/investee companies, although this may not be upheld by the courts.

It should be considered what combination of shareholder authorisation and board authorisation best fits the circumstances of the transaction in question, and put these in place. It will generally not be appropriate to leave conflicts of interest or duty of investor directors to be dealt with in the articles alone. Note that a company needs the requisite ordinary resolution to be passed to take advantage of the board authorisation procedure if it was incorporated before 1 October 2008.

While the articles seek to address issues of conflict of interest and conflict of duty arising from being investor directors or directors of parent or sister companies, such directors should continue to take steps to manage potential conflicts as this will assist in the event that the courts clarify the current law to say that such articles are not sufficient.

Article 31 footnote

If a private company was incorporated before 1 October 2008, an ordinary resolution must be passed in order for the board to be able to authorise conflicts and a footnote should be inserted here to the effect that: “by ordinary resolution on [] 200[] the members of the Company resolved for the purposes of paragraph 47(3)(b) of Schedule 4 to the Companies Act 2006 (Commencement No. 5, Transitional Provisions and Savings) Order 2007, that authorisation of conflicts of interest may be given by the Directors in accordance with section 175(5)(a) of the Companies Act 2006 at any time following the date of that resolution.” Alternatively, a copy of the resolution should be attached to the articles. It should also be noted that this ordinary resolution needs to be filed within 15 days at Companies House. For a private company incorporated on or after 1 October 2008 an ordinary resolution is not needed. The inclusion of an express power in the articles is not a legal requirement for a private company and is not included here, but wording could be inserted for clarity.

Article 31.2

Consider if this article needs tailoring to the structure of the investment fund in question. (*See above for discussion regarding question of enforceability of this article.*)

Article 31.6

Whilst giving the directors flexibility in relation to what terms and conditions they attach to any authorisation given under section 175 of the Act is sensible as detailed in article 31.5, it will probably be preferable, from the investor’s perspective, to carve out the investor director from these terms and conditions at least in relation to counting in a quorum and voting rights.

Article 32: Notices

This article sets out details of how notices can be served by the company (by hard copy, in electronic form or by website), subject to the relevant provisions of the Act having been complied with. It also deals with when notices sent by the above methods are deemed to have been served, replacing the default provisions as to deemed delivery in the Act. This article should be read alongside the relevant clause of the investment agreement to ensure that the same methods of service are used, and that the date on which notices are deemed to be received are consistent.

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

Article 33: Indemnities and Insurance

Articles 52 and 53 of the Model Articles are deleted and replaced by this article.

There is a general prohibition from exempting directors and auditors from liability where they are negligent, in default or in breach of a duty or trust under section 232 of the Act.

The provisions of chapter 7 of part 10 of the Act allow companies to take advantage of a specific exemption that enables them to indemnify directors against liabilities to third parties. Companies are also permitted to pay directors' costs of defence proceedings as they are incurred (subject to an obligation to repay if the defence is unsuccessful).

This article permits indemnification of directors and other officers of the company to the extent permitted by the Act. The article also enables the directors to purchase and maintain directors and officers insurance. Care should be taken to ensure that any insurance that is purchased covers the extension in indemnification that the company is now able to offer.

This article also reflects the fact that companies are now permitted to indemnify directors of a company that is a trustee of an occupational pension scheme against liability incurred in connection with acting as trustee of that scheme.

The directors should also consider whether they are happy to rely solely on an indemnity provision in the articles, as there are some uncertainties about a director's ability to enforce a provision such as this in his own favour (the articles form a binding contract between the company and its members but a director is not party to this arrangement). The directors may want to enter into some form of separate contractual indemnity with individual directors.

Article 34: Data protection

The optional wording in this article relates to the provisions of the Data Protection Act 1998. As a result of this act, certain personal data obtained by a company must be kept confidential. This article provides a form of consent from the shareholders and directors of the company for the time being to this personal information being disclosed in certain circumstances such as due diligence exercises in connection with a potential purchase of the company. Note that as the directors are not parties to the articles, a similar provision should be included in their service contracts.

Article 35: Secretary

The requirement for private companies to have a company secretary is being relaxed with effect from 6 April 2008 under the Act. Private companies will then be able (subject to any overriding requirement in their articles) to dispense with a company secretary.

This article states that the directors may appoint a secretary but they are not required to do so.

Article 36: Lien

This article confers on the company a lien (which is a right which entitles a party to hold on to assets in his possession pending payment of a debt owed) on every share that is not fully paid, for any indebtedness of the shareholder, whether or not the indebtedness is in respect of the shares concerned and regardless of whether it is payable at the given time.

As an alternative to this provision, include a narrower provision which only confers on the company a lien on every share that is not fully paid for any money payable at a fixed time or

called in respect of the share. Alternatively, in some situations, a wider lien covering all indebtedness owing from any shareholder to the company may be preferable.

Article 37: Call Notices, Article 38: Forfeiture of Shares and Article 39: Surrender of Shares

These articles supplement the provisions conferring a lien on the company and contain provision for:

- (a) calls to be made by the company requiring the payment of unpaid capital due in respect of shares;
- (b) forfeiture of the shares in the event that the call is not met; and
- (c) surrender of the shares, if the shareholder so chooses.

These articles, therefore, provide a mechanism for the company to require payment of unpaid capital.

Table A contained similar provisions, but these were not retained in the Model Articles. These provisions largely mirror the provisions in the model articles for public companies.

These provisions may not be needed if the company will never issue shares nil or partly paid. Bear in mind that the other provisions of the BVCA model articles will also require amendment if they are to be prepared on the basis that the company will always issue shares fully paid.

Appendix A: Pay to play

A "pay to play" provision penalises existing investors who fail to purchase at least 50% of their pro-rata portion of a subsequent investment round by losing their right to the anti-dilution protection set out in article 10 above.

An alternative approach is that failure to participate in the round results in automatic conversion of the relevant investor's series A shares into ordinary shares or another less valuable series of preference shares.

Appendix B: Redemption

The right of redemption is the right to demand, under certain conditions, that the company buys back its own shares from its investors at a fixed price.

A right of redemption is not appropriate for each investment and is not allowed or is limited (for example to a certain percentage of the issued and outstanding shares) in some jurisdictions in continental Europe. In the UK, there are legal requirements that must be satisfied before a company can redeem any of its shares.

If this article is included, an investor majority may, subject to the Act, serve a redemption notice on the company requiring it to redeem all of the series A shares. The circumstances in which a redemption can be demanded are if:

- the preference dividend due under article 4.2 is not paid within a given number of days of its due date for payment;
- the company fails to redeem shares in accordance with these provisions within a given number of days;
- a resolution to wind the company up, to reduce the company's share capital or varying the rights of the series A shares is proposed.

Consider whether there are other circumstances in which the investors should have the ability to elect to redeem their shares. For example, if there hasn't been an exit within a specified period.

The provisions provide in the alternative for the series A shareholders to elect to redeem some of their shares or, for all of the series A shares to become due for redemption immediately on service of a redemption notice.

The remaining provisions address the mechanics of the redemption. They also address the situation where the company is prevented by law from redeeming all of the shares in the redemption notice. In such circumstances, the company is obliged to redeem such number of shares as it is able to do, and if there is more than one shareholder redeeming shares a pro rata proportion of each shareholder's shares will be redeemed. The remaining shares shall be redeemed as soon as the company is able to do so, and the preferential dividend referred to in article 4.2 will continue to accrue on these shares up to the date of redemption.

However due to the changes in the accounting treatment for redeemable shares (under Financial Reporting Standard 25, the amount to be paid back will have to be shown as a financial liability on the company's balance sheet). It may not be attractive to have redeemable shares in existence.