SHOOSMITHS

Advance subscription agreements

www.shoosmiths.com

FOR WHAT MATTERS

What is an advance subscription agreement?

An Advanced Subscription Agreement (ASA) is an agreement to pre-pay for shares that will be issued (and priced) at a later stage following a specified trigger event. Unlike a convertible note, an ASA cannot be repaid in cash – it is purely an equity agreement because the funds will always convert into shares. In the United States, an ASA is known as a SAFE (simple agreement for future equity).

Key terms	
Conversion triggers	• Automatic conversion upon a qualifying fundraising, sale, IPO or insolvency event. • Most ASAs will specify a longstop conversion date. In order to be S/EIS compliant this must be no later than 6 months after the date of the agreement. • Investor may negotiate an option to convert upon a non-qualifying fundraising.
Valuation	• In a priced trigger event scenario (e.g. fundraising, sale etc) shares will be issued at the subscription price/ sale price, less a pre-agreed discount. • In a non- priced trigger event scenario (e.g. insolvency/longstop) valuation is more difficult. Valuation options include setting a fixed price often based on a previous series' valuation (which can result in a share price that is not reflective of the current value of the business, especially in liquidation scenarios) or referring valuation to an expert (which can be costly/time consuming). • Cap on valuation is also often agreed.
Discount	Typically between 10-30%.
Rights of shares	Technically can convert into any class of share (e.g. most senior share in issue at time of conversion). However, in order to be S/EIS eligible, the shares must be full-risk ordinary shares with no liquidation or dividend preference.
Interest	Interest is typically not charged on ASA funds (and cannot be charged if S/EIS eligibility is sought).
Warranties	Limited or no business warranties. Certain fundamental warranties (capacity, incorporation etc) will be included.

Key terms	
Pre-emption	Some ASAs will grant investors the right to participate in subsequent fundraisings (pro rata on an "as converted" basis) in addition to their shares being issued. This allows them to double up if they choose to do so.
Information rights	Investors may be granted information rights and/or a board observer seat. This would typically be reserved for more significant investments.
Most favoured nation rights	Some ASA investors will be granted MFN rights (in the event that the fundraising company undertakes another financing round utilising ASAs). Will often also extend to subsequent convertible loan note fundraisings (given the similarities in structure/terms).

S/EIS Eligibility

Unlike convertible notes (which HMRC classifies as debt and therefore ineligible for S/EIS relief), HMRC has confirmed that an ASA investor may be eligible to claim S/EIS tax relief. In short, HMRC will not grant S/EIS relief if the ASA functions as a loan or provides significant protections to de-risk the investment. The ASA must be, in effect, a simple equity investment (albeit deferred).

HMRC will specifically not consider ASAs suitable for S/EIS relief if:

1. The subscription payment can be refunded under any circumstances.
2. The ASA can be varied, cancelled or assigned.
3. Interest may be charged.
4. The ASA converts into anything other than ordinary full risk shares (e.g. no liquidation preference and no preferential treatment over dividends).
5. The long-stop date for conversion is more than 6 months post investment.

If advance S/EIS assurance is sought, the application must be made before the ASA is entered into. SEIS relief will, however, only be available from the date of the share issue and a compliance statement (SEIS1) should not be submitted before this date.

Pros and cons

For founders	
Pros	Cons
Quick: Parties do not need to agree on valuation when entering an ASA. ASAs also typically do not contain detailed warranties or other heavily negotiated legal provisions. This makes agreeing terms quicker and less costly than other forms of financing.	**Snowball dilution:** ASAs have a multiplier effect in the post-money calculation. The more ASAs there are, and the further the cap/discounted price is from the new priced equity, the greater the variance between actual and nominal pre- and post-money valuations.
Not debt on balance sheet: Funds contributed under convertible notes are debts owing by the company. This can lead an early-stage company into choppy waters from a solvency perspective and potentially expose directors to personal liability. Funds contributed under an ASA, on the other hand, are treated as equity and therefore are not liabilities on the company's balance sheet.	**VCs may pass if too many unconverted ASAs/convertible notes:** New investors will not be happy if a large amount of equity is being given away to ASA holders in return for a comparatively small amount of money. The existence of ASAs could also prevent a new lead investor from meeting their fund's required ownership targets without triggering a complete company recapitalisation.

For investers	
Pros	**Cons**
S/EIS eligible: Unlike convertible loan notes, investments under an ASA can (if the criteria noted above are met) be eligible for S/EIS tax relief and capital gains tax exemptions.	**Restriction on rights/protections:** In order to get the benefit of S/EIS tax treatment, investors must agree to the relevant criteria outlined above. Some of the necessary criteria are more onerous/unfavourable than VC investors would typically agree to (e.g. a six month longstop date or the requirement for full-risk shares/no liquidation preference).
Tax structuring: An investor's S/EIS investment is deemed to have been made on the date that they are issued the shares (not the date they enter the agreement). If structured properly, this may allow investors who have exhausted their S/EIS entitlement in the current financial year to treat an investment as part of their EIS entitlement for the following year	**Lack of pricing certainty:** The trade-off for not expending time and energy on conducting a priced round is a lack of pricing certainty. Ultimately, ASA investors are relying on the accuracy of a future investor's modelling/diligence and the agreed discount to ensure they receive an adequate return on their investment.
	Less protection in liquidation scenarios. Under an ASA, an investor will rank alongside ordinary shareholders (unlike in a convertible note financing scenario, where they will be a creditor and therefore rank ahead of all equity holders). Further, in order to enjoy the benefit of S/EIS treatment, the investor must not have any liquidation preferences attaching to the shares (meaning they will rank alongside the other ordinary shareholders and behind any existing preference shareholders).