

Start Up Company Finance – the zigs and zags

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There never has been so many financial products available on the market to start or finance a business as there are available now. However in practice, since the dotcom bubble burst, September 11th and the general downturn in equity markets, it has proved very difficult for early stage companies with no track record to raise equity capital.

Who to go to Few start up businesses can self finance until they have positive cash flow. The vast majority of businesses need finance from third parties.

Banks. Traditionally the banks have been the first port of call for small businesses. The most recent EU Commission communication on the implementation of the Risk Capital Action Plan, indicates that banks have on average been the source of 26% of all funds raised in Europe in private equity markets. However, banks generally provide debt finance, ie term loans and overdrafts and may require the company and its directors provide collateral. For those banks with private equity arms, the year 2002 saw a clear trend of banks starting to dispose of these operations. It is not clear at this point to what extent the venture capital segment will be affected.

Government. Governments have traditionally sought to fill the gap which the private sector has been unwilling to fulfil. In 2001, the EU Commission in its Communication on State Aid and Risk Capital, set out how they would apply the State Aid rules to measures designed to provide or promote risk capital, such as the provision of aid to investors or enterprises, or to intermediary vehicles or funds. Among the schemes approved under the Communication, was the UK small and medium enterprise Venture Capital and Loan Fund which focuses on the provision of equity and quasi equity as well as micro-finance loans to SME's.

Further in the most recent UK budget, changes to the venture capital trust ("VCT") rules have resulted in the launch of a raft of new VCT's as the UK government has extended income tax relief (from 20 to 40%) for investments made in VCT's. In addition, the amount that can be invested per year in a VCT has been increased. In Ireland, the Government has committed 95 million Euro through Enterprise Ireland ("EI") to partner with the private sector. In that context EI has committed to 15 funds some of which are intended for early stage small and medium sized enterprises and sectors that are traditionally difficult to finance such as biotech.

Angels. Some start ups are able to secure equity injections from wealthy private individuals or a network of individuals. Generally these people will invest where the project reflects an area where they have expertise and fits into their contacts network or where the project has similarities with previous projects that they have invested in. However, since the dotcom bubble burst, this source of finance is harder to come by.

Two other sources of investment can be considered, investment by the strategic investor and by the venture capitalist.

Strategic investor. For early stage companies (particularly in the biotech and pharmaceutical sectors) which lack the finance, distribution infrastructure or expertise to market and distribute their products successfully, securing equity capital at an enhanced value for the business from a strategic investor is a possibility. In exchange, the strategic investor may want an exclusive licence to the technology/know how and shares in the company. The complexities generated by combining an equity investment with a licensing and distribution deal and the fact that the investment decision has to be approved by any number of layers of management in the strategic investor, mean that the time taken to secure the investment is longer.

Venture Capitalist. The more usual route is for the company to approach a venture capitalist (“VC”), although because of the high risks involved, VC’s are essentially interested in companies with a potential for high growth. The right VC will add credibility, supply management expertise and contacts. However, it is important that the company understands at the outset what securing a VC investment entails. The VC will normally seek a significant part of the equity in the company, warranties and indemnities in relation to what has been going on in the company, will require his consent is obtained on important issues affecting the business and the company and very often the right to appoint a non executive director to the board of the company and clear exit rights.

Preliminaries. Before approaching any VC, talk to your lawyer and your accountant, as advice can be given at an early stage on matters which will affect the success or failure of the search for finance. Consider the following: first, ensure the structure of the company does not impede an arm’s length investment by a VC; second, ensure your products are properly protected by intellectual property rights (patents, copyrights, design rights, trade secrets etc) (“IP rights”) and that they are free of claims from third parties; and third, structure upstream and downstream licensing/ distribution arrangements (very often they are not properly structured). Finally, work on the business plan.

Advice can also be given on which venture capitalists are most likely to suit the needs of the start up and sometimes introductions can be effected to investors.

Because the company may be asked to warrant what is in the business plan, it needs to be drafted with great care such that it does not constitute an invitation to subscribe for shares, fall foul of financial services legislation or be construed as a prospectus.

On the IP protection issue, many early stage companies, even at second round financing stage, are reluctant to incur costs in protecting their inventions by patents, as the argument is made that they can easily be designed around. This is not an excuse for doing nothing. If a cluster of ideas can be protected by one or more patents, then significant barriers to entry can be created, as the patent owner is given the right to prevent others from making, offering, putting on the market or using a product which is the subject matter of the patent, or importing or stocking the product for those purposes . On the cost issue, the EU Regulation for a Community Patent has been agreed politically since March 2003. Hopefully agreement will be reached shortly on

the issue blocking consensus, ie the legal status of patent claims where translations are inaccurate. When adopted, it will apply directly throughout the Community and without the need for member state implementing legislation and is expected to satisfy the key issues that have arisen for patent applicants, ie affordability, particularly on translation requirements (it is expected to halve these). The Regulation also will make as much use as possible of existing facilities within the Community

Control of the business . One of the key concerns for the founder/ shareholders, is not to lose control over the company. However, the controls demanded by the VC will often be the same whether it is subscribing for 15% or 50% of the company. From the perspective of the founder shareholders, in general terms (because a lot depends on the level of control that the investment agreement allows for) the more important issue is the size of shareholding they manage to retain, as this will determine the level of income (by way of dividend) and how the proceeds of sale of the shares are apportioned.

In addition, the VC investor will typically require that employee agreements are terminable at short notice, whereas founder employees will want no early termination and no compulsory transfer of shares on their leaving unless they are in default. This point is often heavily negotiated.

Issues with shares. On the issue of shares and what type of shares, the most important issue is not how the shares are labelled (ie preference or ordinary etc) but what rights and obligations attach to the shares. Preferred shares, for example, often have conversion rights allowing their conversion into ordinary shares on certain events happening. These conversion rights can be of benefit but also can have serious consequences for founder shareholders where the company has failed to meet targets in a business plan.

For example, some VCs will wish to provide founder shareholders with adequate incentives to achieve targets in the business plan, by subscribing for a mixture of ordinary shares and progressively convertible redeemable preference shares incorporating a ratchet. The preference shares are convertible into ordinary shares at variable rates depending upon the company's profit performance. If the profits reach the anticipated targets, the company has the option of redeeming certain tranches of the preference shares. If the profit targets are not met, those tranches are converted into ordinary shares. In this way the founder shareholders equity ownership and entitlement to dividends becomes more valuable as the VC shareholding is reduced. The precise details of the ratchet structure will be governed by tax considerations. However on the other hand if the profit targets are not met, the VC's shareholding increases.

So at the outset, the pricing of the slice of equity traded by the company for the VC investment is critical, as also are the events and mechanisms which would trigger a conversion of preference shares into ordinary shares and how if converted, the balance between the shareholders would be affected.

Exits and Share transfers. Both these areas are invariably complicated, require careful review and are often heavily negotiated. Generally, one will find that investors impose a prohibition on founder shareholders selling for a stated period in order for example, to tie in management who are also shareholders.

Because VC funds have a limited life, the VC may impose certain obligations on the founder/shareholders designed to achieve realisation of the investment in a particular period of time. A best endeavours obligation such as this, incorporated in an investment agreement, that imposes an obligation to do *everything* that is possible in the circumstances, is clearly onerous and should only be given after taking proper advice.

Aside from provisions (which are often negotiated) enabling the VC to realise his investment in the context of a listing in priority to other shareholders, the VC may require the grant of a put option, so that if realisation of his shares is not achieved by a certain time, he may require the founders to purchase his shares at a formula price or require the founders procure the company buys his shares.

The VC exit rights will have to align with detailed provisions on share transfers. Generally, such provisions, contain a pre-emption clause which entitles shareholders usually on a pro rata basis to a right of first refusal to buy the shares which are for sale before they can be offered to an outsider.

Share transfer provisions normally involve detailed negotiations on compulsory transfers (such as when an employee/shareholder leaves), drag along rights giving the selling shareholder the right to require that the other shareholders join in a sale to a third party, ordinarily at the same price per share as that being offered to the selling shareholder and tag along rights giving the non-selling shareholders a right upon a sale to a third party to join in such sale again ordinarily at the same price per share.

It is vital if one or more third party valuers are to be used in calculating the price at which shares are bought and sold under share transfer provisions, that the articles or investment agreement contain detailed provisions setting out for the valuers, guidance on the method to be used, the timing and gathering of evidence for the valuation to be made.

A single market in risk capital. In the EU context, the Commission recognised back in 1998 that a flourishing market in Risk Capital is key to job creation. The question is what progress has the EU achieved in creating a single market for Risk Capital. In practice, a host of measures have been and are being proposed, some of which have been implemented or will shortly be implemented. We mentioned above the status on the Community Patent Regulation. The draft Directive on the patentability of computer implemented inventions (currently such inventions are patentable subject to conditions in some countries but not in others) is at second reading stage before the European Parliament. The new Directive on Prospectuses (2003/71) will make it easier and cheaper to raise capital across the EU on the basis of a seal of approval granted by a regulatory authority of a member state. Additionally, the Occupational Pension Funds Directive (2003/41), once transposed into local laws (adoption is imminent in the UK as part of the Pensions Bill and in Ireland through the Social Welfare bill in March 2005), will provide additional opportunities to allow

institutional investors to invest in venture capital. The Commission has proposed and is looking at many other measures and issues, including at the thorny issue of share options.

Whatever the EU dimension, from the outset, get organised and take legal advice not only on the business plan, but also on structuring your company and raising capital. Where your business is being built on developing products in which IP rights subsist and on distributing third party products, make it a central element in your business plan that you secure capital to properly protect your products as they are developed. Finally, properly structure your distribution and licensing arrangements, whether upstream (bought or licensed in) or downstream (distributed out or licensed out).

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