Investment for Business Growth
The Legal Side Explained

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Ltd – Limited Company

- Start up corporate vehicle of choice – Why?

- “The limited liability corporation is the greatest single discovery of modern times....” Nicholas Murray Butler, president of Columbia University winner of the Nobel Peace Prize

- “Corporation”: an ingenious device for obtaining individual profit without individual responsibility. (Ambrose Bierce, The Devil's Dictionary)
Appeal for Orderliness

 “Good order is the foundation of all great things.” Edmund Burke

 ... and it will be helpful in winning investment too... Why?

 Potential investors will carry out “due diligence” and review the records, accounts and other documentation of the company
Which agreements does a start-up need?

• Standard contract on which the business provides its goods and/or services incorporating standard ‘terms and conditions’

• NDA (confidentiality agreement)

• shareholders’ agreement

• any ‘funding agreements’ – loan agreements are a good example

• a consortium agreement – application for grant funding

....anything .... so long as it’s clear....!
What do you mean by “Investment”?

Investment may come in the forms of:

1. Equity Finance; and/or

2. Debt Finance
1. EQUITY FINANCE

- Raising capital from the founders and external investors in return for shares ("equity") in the business.

- Most commonly sought (after the founders, family and friends) from business angels ("BAs") and other high-net-worth individuals.

- Crowd funding – a new departure
1. EQUITY FINANCE - Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS)

- EIS and SEIS enable individual investors to claim relief on income and capital gains tax when investing in companies that qualify under the schemes.

- Any start-up company should apply for pre-approval and subsequent approval as soon as possible to make itself a more attractive investment.

  • There are a number of conditions attached relating both to the investor and the investee company, which could form the basis of a separate talk.
1. EQUITY FINANCE - Advantages of Equity Finance

- The funding is committed and investors only realise their investment by sale of their shares.

- BAs bring valuable skills, contacts and experience to the company. They can also assist with strategy and key decision making.

- Investors have a vested interest in the business’s success (i.e. its growth, profitability and increase in value).

- Investors are often prepared to provide follow-up funding (loans as well as equity finance) as the business grows.
1. EQUITY FINANCE - Disadvantages of Equity Finance

- Raising equity finance is demanding, costly and time consuming.

- Legal and regulatory issues (e.g. prohibition of offers to public s.755 Companies Act 2006 (the “CA”), promoting investments, s.21 Financial Services and Markets Act 2000)

- Potential investors will:
  - seek background information on your company and your business;
  - closely scrutinise past results and forecasts; and
  - probe the management team.
1. EQUITY FINANCE - Disadvantages of Equity Finance cont......

- Power to make management decisions may be lost.

- The company will have to provide regular information to the investor to monitor the business.

- The founders’ percentage shareholding in the business will be diminished, however this may lead to greater monetary rewards (bigger pie, smaller slice, but worth more).
1. EQUITY FINANCE - Dilution of Shareholdings

- The CA protects (to an extent) shareholders from ‘Dilution’.

- ‘Dilution’ is what happens when shares are issued to new shareholders and this reduces the percentage shareholding of the existing shareholders.
1. EQUITY FINANCE - Protection from Dilution

- s.561 of the CA provides that a company must offer each shareholder pro rata to his or her existing shareholding an allotment of shares when new shares are issued on the same or more favourable terms to the shares already owned.

- Existing shareholders have the chance to protect their percentage share holding by investing more money.

- The company must give the existing shareholders at least 14 days to respond.
1. **EQUITY FINANCE - Strengthening/weakening of protection**

- Majority shareholders may want to weaken pre-emption rights of minority shareholders

- Minority shareholders the opposite!

- It is not in the interests of the minority or majority to prevent further investment in the company.

- May be achieved by amendments to the articles of associations (but beware as the articles are available to the public from Companies House)
1. EQUITY FINANCE - Shareholders’ Agreement

- In addition to, or instead of, amending the articles of association, shareholders and the company often enter into a contract (the shareholders’ agreement).

- The shareholders’ agreement sets out the rights of shareholders on the issuing of new shares and transfer (sale) of shares they already own and governs the relationship between the interests of the majority and minority shareholders.
Crowd Funding – the future?

What is it? Raising funding from the public via a website;

Donations Model: Kickstarter, Indiegogo, Crowdfunder, Wefund, Peoplefundit; (participation in merchandise or product development – no shares);

Shares Model: Crowdcube, Seedrs and BritDAQ - compliance with FSMA via a regulated person;

Comment:
- A good idea – supported by lobby groups;
- Risks – “boiler room” scams etc, which is why s.21 of FSMA exists;
- Way forward - more relaxed regime (perhaps like US JOBS Act).
2. DEBT FINANCE

- As well as equity finance, companies may be able to obtain ‘debt finance’:
  - Loans from shareholders, family members or friends
  - Bank loans:
    - Term Loans; or
    - Overdraft facilities
  - Loans from other specialists providers:
    - Zopa, Funding Circle, Money & Co (not launched)
2. DEBT FINANCE - Personal Guarantee

- Usually a bank will require a personal guarantee from the shareholder/director.

- **Advantage** – the bank will lend the company money.

- **Disadvantage** – defeats (to an extent) limited liability because the guarantor is personally liable to the bank if the company fails to repay its debts.

- Point to note: a high street bank will only take a limited guarantee (e.g. up to £X,000 plus costs and expenses) not an unlimited one.
Summary

- Companies have a variety of funding options.

- Business founders need to balance the desire for control, need for funding, and amount of personal risks they want to take.
THANK YOU
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