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The Start-up Brief

Getting investment for your business and obligations to your shareholders

This FAQ sheet forms part of a series prepared by postgraduate students from the University of Manchester's School of Law, in conjunction with the Legal Advice Centre. They are intended as an introductory guide to commonly asked questions by those approaching the Manchester Enterprise Centre when seeking advice on starting up new businesses.

These guides provide only a basic overview on key issues to be considered and do not constitute legal advice. Further detailed advice should be sought as necessary from appropriate professionals such as a solicitor or accountant.

Many companies need some form of financing in order to get up and running. For the majority of businesses this will take the form of personal savings, grants or loans. The latter will be sourced from either friends, family or from the bank. However, for a minority of businesses substantially larger sums are required at very early stages and this is where equity finance comes in. This involves individual investors such as Business Angels or Venture Capitalists investing into a business in return for a share of that business. As with all forms of funding there are many issues that should be considered before entering into such arrangements, e.g. 'cost' of money both in financial and possibly relationship terms, changes in ownership, risks to yourself and to the business, etc.

This FAQ sheet focuses purely on the legal aspects around equity investment answering a number of key questions as listed below. Some tips to consider when pitching to investors are given at the end of this FAQ sheet.

1. What is a term sheet and what legal issues should you consider before agreeing to investment or accepting shareholders?

2. As a business owner / founder, what should a shareholder agreement cover and what obligations do you have towards your shareholders?

3. What are the legal issues to be considered when setting up and running a crowdfunding campaign?

Q1: What is a term sheet and what legal issues should you consider before agreeing to investment or accepting shareholders?

Share financing involves selling ownership rights in the company to investors by issuing stock. Investors are hopefully rewarded for financing companies through increased share value and possibly dividend payments. In negotiating such an important deal which impacts on fundamental aspects of business, namely its economics and control, what is it that the founder (s) should be thinking about.

Well to a large degree you should be focusing on the key aspects covered by a term sheet. This is the document that outlines the terms by which an investor (angel or venture capital investor) will make a financial investment in your company. It serves as a notice of intent to invest and the beginning of a period of negotiation concluding, if all goes to plan, in a signed shareholder agreement. The terms covered by the term-sheet will describe things like the agreed upon valuation of the company, the price per share for the investment, the economic rights of the new shares and so forth. Generally, a term sheet itself is not legally binding. Its main purpose is to serve as a blueprint for the formal legal document that will be drafted by lawyers, the shareholder's agreement.

The term sheet covers several key terms which you should pay attention to and these broadly fall into two categories, economic (Terms 1-5, Table 1) and control (Terms 6-8, Table 1). Once successfully negotiated, the incremental benefit of negotiating other terms diminishes pretty quickly.

Table 1: Key Terms that are covered within a term sheet

1. Valuation (and percentage ownership)

The company's valuation, along with the amount of money invested, determines the percentage of the company the new investors will own. This is one of the most crucial components of the term sheet, because it has the most direct impact on who owns what and how much cash each shareholder receives when the company sells. Valuation is expressed in terms of pre-money and post-money values. The pre-money valuation is the company's valuation before the new investment. The post-money valuation is simply equal to the pre-money valuation plus the amount of the new investment. The founder's basic objective is to maximize the amount of capital investment while minimising dilution.

2. Option Pool

Most term sheets will stipulate the creation of an option pool or the expansion of an existing one to set aside shares for future hires / employees. The language generally looks something like this: 'Prior to the Closing, the Company will reserve shares of its Common Stock so that [XX] % of its fully diluted capital stock following the issuance of its Series A Preferred is available for future issuances to directors, officers, employees and consultants.' The language here is crafted very carefully.

The key phrase is, "prior to the closing....". What this means is that the investors want some percentage of the capital to be set aside for future grants, but they want existing shareholders to absorb all the dilution. The option pool is a common source of information asymmetry, because many founders do not understand how VCs think about valuation.

3. Liquidation Preference

The liquidation preference is downside protection for preferred stock, and it is a pretty standard term. The most standard liquidation preference is 1x invested capital, which means that when the company is sold, preferred stock holders are entitled to receive an amount equal to what they invested before more junior classes of stock can receive anything. Or instead, preferred shareholders can convert their shares into common and receive cash according to their percentage ownership in the company (if doing so would give them a greater return).

4. Dividends

Dividends, expressed as a percentage (e.g. 8%), provide an additional return that accrues to preferred stockholders over time. Any dividend that accrues to preferred stock increases the liquidation preference by that amount. Pretty much all term sheets mention dividends, but depending on the language, the section may be effectively pointless. Most founder friendly dividend language will include the word "noncumulative" and the phrase "when and as declared by the Board of Directors." With these two features, this term will likely never come into play.

Watch out for the word "cumulative" or the acronym "PIK," which stands for "paid in kind." Cumulative dividends essentially guarantee investors a certain level of return, which is not a very standard feature for early-stage deals. PIK dividends are a double whammy, because the value of the dividend is paid to the investor in the form of additional preferred stock. This not only increases the liquidation preference for preferred stock, but it can also dilute the founders share-holding over time as more cumulative dividends are paid out.

5. Anti-dilution

Anti-dilution is a pretty standard feature of preferred stock. It protects investors from getting grossly diluted in the event of a "down round" (i.e. the Series A round was raised at $2 per share and later a "down round" occurs when the Series B round is raised at $1.50 per share). Anti-dilution protection comes in several forms: full-ratchet, narrow-based weighted average and broad-based weighted average. Broad-based weighted average is the most founder friendly form of anti-dilution. Adding a "pay-to-play" provision requires an investor to invest more capital in a down round in order to receive anti-dilution benefits. In general, you're mostly safe if anti-dilution is either of the two weighted average varieties.

Full-ratchet anti-dilution can be pretty devastating to common shareholders in a down round. Hopefully anti-dilution never comes into play. But if it does, full-ratchet can effectively wipe out common stockholders, so avoid it if you can.

6. Board of Directors

The board is a crucial governing body in any company, and term sheets will often include provisions on how it will be structured and who will control critical board votes. As with other terms, there are more founder-friendly options and less founder-friendly options. Many feel that the ideal structure, even for later-stage companies, contains an equal number of VC-friendly members and founder-friendly members, as well as an "independent" board member. The independent member is usually a respected business person who is trusted by all other board members. The primary objective for founders is to make sure that board representation between VCs and founders/common shareholders stays equal. Under these circumstances, both sides have equal voting power. In a situation where the two sides disagree, neither side would be able to win without convincing the independent member to vote in their favor.

7. Ownership Percentage of Share Classes

Some company decisions depend on a shareholder vote rather than a board vote. For these decisions, voting power comes down to percentage ownership (see Start-up Brief: 'Setting up a company and a director's duties' for more details). So the main concern is whether or not majority ownership of the company is held by founder-friendly shareholders or VC-friendly shareholders.

8. Investor Rights

Investors typically require special rights called "protective provisions" before they agree to invest. They can include things like limits on how much debt you can take on without VC consent, restrictions on increasing authorized shares to take on new funding or give to employees, and changes to the certificate of incorporation.

Q2: As a business owner / founder, what should a shareholder agreement cover and what obligations do you have towards your shareholders?

Issuing shares or share allotment is one of the ways to generate new capital for the company. In a private company with single class of shares, directors are normally allowed to allot shares, unless prohibited or subject to approval according to the articles of association.

A major issue with equity finance is that in return for investment you sell a share of your business which will impact control of your business. Control of the company is pretty much binary: either you have it or you do not. If your share of the company is below 50% + 1 share you do not. However, even for stakeholders with a minority stake in the business, they have certain rights and they key ones are detailed below as well as in table 2 which also illustrates how some of these rights vary according to the percentage of shares held.

Once a business has one or more shareholders, under the Companies Act 2006, major business decisions which would affect those shareholders' rights must be approved by the shareholders at a general meeting called by the directors of the company, by way of special resolution. Directors have a duty to call General Meetings of members. However, members holding more than half of voting rights can call for general meetings if the directors fail to do so. Directors also have duty to approve and sign annual accounts which are submitted to all members.

In general, shareholders have little power over the directors and how they run the company but ultimately shareholders do have the power to remove a director before the expiry of their term by ordinary resolution. The main role of a shareholder is to attend meetings and discuss whatever is on the agenda to ensure the directors do not go beyond their powers – and provide shareholders' consent where required. However, certain decisions can only be made by the shareholders such as changing the name of the company, authorising a service contract for a director which gives him or her job security for more than two years or approving substantial transactions. They are entitled to receive the annual accounts and reports of directors and those of the auditor. The accounts must also be approved annually by the shareholders. Shareholders take decisions through ordinary or special resolutions (the latter requiring specific notice to be given). A shareholder in a company normally is paid dividends out of the company profits.

Shareholders do have both rights and obligations and these should be specified in the shareholder's agreement which is a legally-binding document. These agreements are entered into by shareholders to regulate their relationship and how the company will run, as-well-as solving inter-shareholder disputes that may not have been provided for in the articles of association.

Many clauses in a shareholders' agreement operate as voting agreements. The parties bind themselves to exercise their votes as shareholders, putting into effect their agreed intentions as to how the business will be funded, run and developed. Some typical examples are given below (1-4).

1. **Rights of veto.** Other parts of the agreement often provide that important decisions, whether or not they would ordinarily be taken by the directors or the shareholders, cannot be made unless all shareholders agree to them - so minority shareholders can veto them.

2. **Issue and transfer of shares.** On issue of shares, these provisions must balance the need for the company to be able to issue shares to raise further funds against the danger of a shareholder finding their shareholding has been diluted by an issue to other shareholders.

3. **Rights to appoint directors.** Shareholder agreements to protect outside investors may provide that they can appoint a director to the board of your company, to protect their interests.

4. **Dispute resolution.** Agreements may contain a mechanism for resolving disputes, such as referral to a third party expert or arbitrator, or a buy-out mechanism whereby, if a dispute occurs, one side buys out the shares of the other at a price determined in accordance with the agreement. It can even provide that, in the event of an unresolved dispute the parties agree to vote to wind the company up.

Q2: As a business owner / founder, what should a shareholder agreement cover and what obligations do you have towards your shareholders?

Table 2: Special protections applicable to shareholders according to the % of shares they hold

1 share	The liquidation preference is downside protection for preferred stock, and it is a pretty standard term. The most standard liquidation preference is 1x invested capital, which means that when the company is sold, preferred stock holders are entitled to receive an amount equal to what they invested before more junior classes of stock can receive anything. Or instead, preferred shareholders can convert their shares into common stock and receive cash according to their percentage ownership in the company (if doing so would give them a greater return).
5%	This level of ownership gives a shareholder more ability to influence the affairs of the company, including the right to: require a resolution to be proposed at shareholders' meetings; require a general meeting be held; require the company to circulate to members a statement relating to a matter referred to in a proposed resolution to be put to shareholders' meetings; and prevent the deemed re-appointment of the company's auditor.
10%	A shareholder owning 10% of the company's shares has the ability to block the holding of a general meeting of shareholders' on short notice.
15%	A shareholder owning 15% of the company's shares has the right to object to a variation of the class rights of the shares he holds (by requesting that the court cancels the variation).
25% + 1 share	To pass a special resolution, 75% of shareholders must vote in favour of it. Therefore, a special resolution cannot be passed if a minority shareholder owning 25% +1 voting shares in the company opposes the resolution. Special resolutions are used for a variety of issues, e.g. alteration of articles of association; offer to issue shares in the company to existing shareholders other than on a pro-rata basis by disapplying pre-emption rights; reduction of share capital (also subject to confirmation by the court); to give, revoke, renew or vary the authority for the company to purchase shares in itself; change of name; re-registration of private company to public company; to redeem or purchase own shares out of capital; and voluntary liquidation.
50%	To pass an ordinary resolution, a majority of shareholders must vote in favour of it (i.e. 50% + 1 voting share). Therefore, an ordinary resolution cannot be passed if a shareholder holds exactly 50% of the company's shares. Ordinary resolutions are required to be passed (amongst other things) to implement the following: appointment of director (although this will be dependent on the terms of the company's articles of association); removal of a director; entering into a service contract with a director for a period of more than two years; substantial property transactions involving the transfer of property between the company and a director; the making of loans or quasi loans to directors and persons connected with directors; payment to a director of compensation for loss of office; ratification of past actions of the board of directors where they acted without authority; removal of auditors; authority for the directors to allot shares; alteration of the share capital; to give, revoke, renew or vary the authority for the company to purchase shares in itself; and approval of a company voluntary arrangement.

Q3: What are the legal issues to be considered when setting up and running a crowdfunding campaign?

Here are four legal issues in your crowdfunding campaign that you need to know and handle before launching it.

1. You are entering a vague yet legally, binding contract with your backers. For this reason, you need to be as specific as possible when describing the reward you will offer. Additionally, you need to ensure that the reward is one you can reasonably fulfill. You can be sued if you fail to fulfill your obligations under the campaign.
2. Check that you are not infringing on someone else's intellectual property. Before launching your campaign, make sure that you have done the work to own the intellectual property. If someone else owns the intellectual property, you need to work with them to get a licence (or other appropriate agreement).
3. You are incurring tax liability. You are liable for paying taxes just as you would on any other business income. However, even if you do not fall into this category, you must report the income when filing taxes.
4. You are incurring risk of personal liability. Crowdfunding platforms are not liable for legal issues that arise from your campaigns. You will be completely responsible. You should consider setting up an actual business entity and running the campaign through that business. That way, the liability will fall under the business and not you personally (unless you do something fraudulent or illegal of course).

Other key points to think about when pitching to potential investors

Things to focus on

1. Financial performance. Prove to potential investors that your company has excellent financial performance, especially if you are seeking funding from a bank. Venture capitalists will look for a potential of high returns and a clear exit opportunity.
2. Background and experience in the industry. Investors look for experienced entrepreneurs and management teams with a track record of high performance and leadership in the company's industry or in prior ventures.
3. Scope and scale of opportunity. Prove to your investors, with concrete evidence, that your market potential is big enough to make investing worthwhile.
4. Effective business model. Present the business model that you are currently using and prove that it will help your company become more profitable.
5. Large market size. Investors look for companies that can grow quickly and manage this high growth scale. Your presentation should flow in a nice, organized fashion. Each section should build logically on the previous section, without requiring the investor to know something that is presented later in the plan.
6. Structure. Each section should build logically on the previous section, without requiring the investor to know something that is presented later in the plan.

Things to avoid

1. Unclear Concepts. One of the most embarrassing mistakes an entrepreneur, or anyone pitching to an investor, can make is to sound confusing or hard to follow.
2. Detail Overload. Cut unnecessary lines and always get to your key arguments to get investors nodding in approval, instead of checking their phones out of sheer confusion or boredom.
3. Not Knowing Your Audience. Before heading into a meeting with potential investors, you need to determine if they would be a good fit for your business model.
4. Lack of Figures and Story. The business world is full of statistics and stoic prose. You can do this by relating your pitch to a real issue in a way that will connect with people.
5. Lack of Anticipation for (Difficult) Questions. Investors may want you to elaborate on some of your points, or they could be testing how solid your business plan is.
6. Showing Too Much Emotion. Be professional, and politely address any suggestions or criticism no matter how misplaced or hurtful it may seem to you. Passion has its place but you must never let your emotions lead you to be rude.