

Bird & Bird

Corporate law for early stage businesses

22 October 2024



Who are we?

Bird & Bird is a leading full-service law firm based in London, with a specialism in IP and technology.

Our Tier 1 Venture Capital group advises high-growth companies as well as investors from angels, VC funds, corporate investors and accelerators within the venture capital ecosystem on all stages of the company life cycles, working closely day to day with colleagues in IP, Employment, Data Protection and Commercial Contracts

- Advising on initial start-up phase – incorporation, initial funding, incentivisation of employees
- Equity funding rounds – family rounds to angel investments to late stage investments
- Debt raises (bank and venture debt)
- Bolt-on acquisitions and joint ventures
- Exit (sale or an IPO)

Introduction

Looking at a few key areas when advising / working with early-stage businesses:

- Choosing the right legal structure for a business.
- Role of directors
- Shareholder arrangements
- Funding rounds
- Exits

Please do jump in with questions at any stage!



Choosing a legal structure

- When to choose your structure – do you need one?
- Which one is right for you?
 - **Sole trader** : full control, privacy, ownership over profits, less admin
 - **Limited company** : funding, contracting, taxation
 - **Charities / CICs**
- The common rule is that when your earnings remain low, it may be best to remain as a sole trader, unless you need other benefits such as limited liability.
- Considerations for choosing the appropriate legal structure: bureaucracy, liability, taxation, control, flexibility and credibility

Aspect	Sole Trader (Sole Proprietorship)	Limited Company
<i>Legal Structure</i>	Simple and easy to set up.	Requires formal registration and compliance with corporate laws.
<i>Ownership and Control</i>	Complete control over the business.	Shared ownership with shareholders, potentially diluting control.
<i>Liability</i>	Unlimited personal liability; personal assets at risk.	Limited liability, personal assets generally protected.
<i>Taxation</i>	Personal income tax rates apply.	Corporate tax rates may be lower. Shareholders taxed on dividends.
<i>Financial Liability</i>	Personally responsible for business debts.	Limited financial liability; company assets separate from personal assets.
<i>Access to Capital</i>	Limited access to external capital; reliance on personal funds and loans.	Easier access to external capital through investors, loans, or shares.
<i>Compliance and Reporting</i>	Fewer regulatory requirements.	Extensive compliance, reporting, and administrative obligations.
<i>Privacy</i>	Limited privacy; personal and business finances are intertwined.	Enhanced privacy; financial information often remains confidential.
<i>Profit Distribution</i>	Full control over profit distribution.	Profit distribution can be complex, subject to corporate rules and shareholder agreements.
<i>Continuity and Succession Planning</i>	Business ends with owner's death or choice to sell.	Continuity can extend beyond owner's involvement; easier to plan for succession.
<i>Professional Image</i>	May be perceived as less established or credible.	Often seen as more credible and established.
<i>Flexibility in Decision-Making</i>	High flexibility to make decisions quickly.	Decision-making may involve more stakeholders and formal processes.

For Profit?

Limited companies typically 'for profit'. Other options in the UK include:

- Charities
 - Purpose of your organisation must be exclusively charitable
 - Register with the Charity Commission
 - Able to claim a number of tax reliefs on most income, capital gains and profits
- Community Interest Company
 - Hybrid between a charity and a profit making company. A Community Interest Company must be set up and run for the benefit of the community.
 - More flexibility in the 'purpose'/ light touch regulation compared to charities

Some funds / grants will only give to charities or community interest companies, because of the protections these vehicles provide that funds will be used for stated purposes.



CERTIFICATE OF INCORPORATION
OF A
COMMUNITY INTEREST COMPANY

Limited Companies

- Vast majority of businesses we work with will be limited companies
- For those that did / remember the LPC – *Salomon v Salomon* was a seminal case, helping to establish the principles of separate legal personality and limited liability
- Drives entrepreneurial activity by allowing business owners to enter into contracts, hire employees, raise funds, etc via their company without incurring personal liability
- This has been copied across the world and limited companies appear in most jurisdictions

Salomon
v.
A Salomon and
Co. Ltd. (1897)
Principles Of Separate Legal Personality
And Limited Liability For Companies



Incorporation

- Very simple process in the UK – to register with Companies House (the UK Registrar).
- You can register online (small fee) and you'll need:
 - the company's name
 - registered address
 - at least one director
 - at least one shareholder
 - details of the company's shares
 - rules about how the company is run - known as 'articles of association'.



Companies House

Ongoing requirements

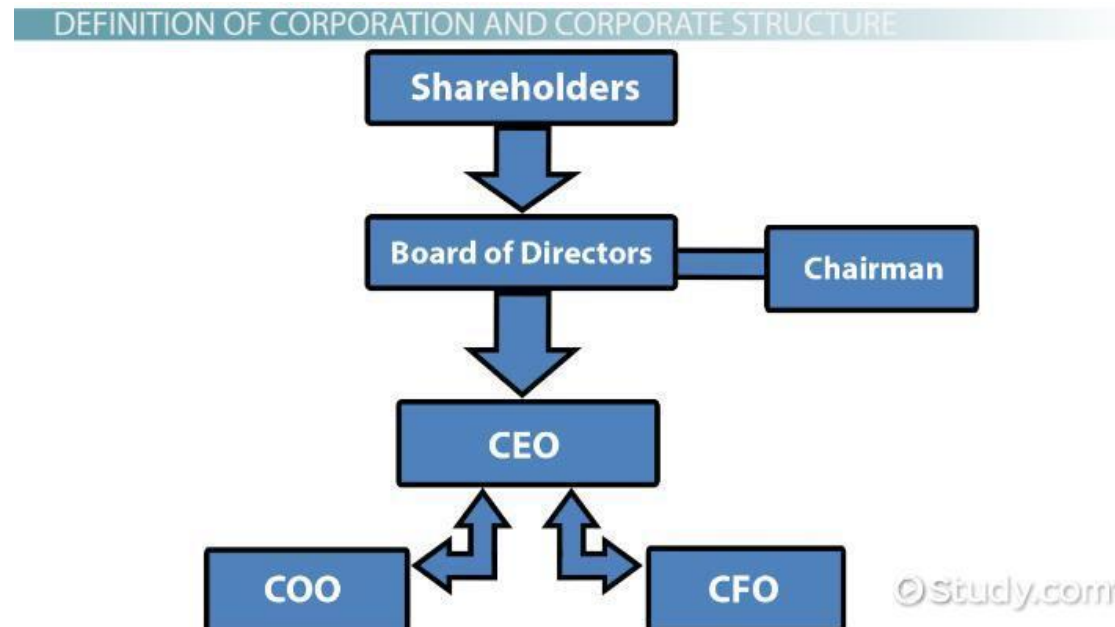
Various administrative requirements for limited companies:

- Register for Corporation Tax
- Annual company Tax Returns and annual accounts
- Annual confirmation statement
- Information about PSCs (people with significant control)
- Any changes must be reported to Companies House



Shareholders

- Shareholders own the company (and appoint the directors who run the company day to day)
- In early stage / family companies, shareholders and directors are often the same people
- Company decision making: shareholder meetings / AGMs
- Important to understand the distinction between shareholders and the company, and respect the separate legal personality of the company – shareholders mustn't treat the company's assets as their own – even if they ultimately own it!
- Maintenance of Capital Rule



What is a Director

- Person (or company) appointed by the shareholders to the Board to run the company day to day
- Statutory directors have certain legal obligations, including filing requirements, and other duties.



Directors Duties

- General statutory duties (Companies Act 2006):
 - To act within powers.
 - **To promote the success of the company for the benefit of the members as a whole.**
 - To exercise independent judgment.
 - To exercise reasonable care, skill and diligence.
 - To avoid conflicts of interest.
 - Not to accept benefits from third parties.
 - To declare any interest in a proposed transaction or arrangement with the company.
- Prospect of personal liability under the Companies Act and under a wide variety of other laws and regulations, such as insolvency, environmental and health and safety legislation.

Funding your Company



- Different sources of funding:
 - Equity investments
 - i.e. issuing new shares for cash
 - no requirement to repay – shareholder will be entitled to dividends/ exit proceeds
 - Loans (banks or shareholders)
 - i.e. normal bank loan
 - must be repaid with interest – difficult for early-stage companies
 - Government grants

Equity investments

- Primarily the type of deals we work on
- Typically minority investments i.e. the founder(s) will continue to 'control' the company (own more than 50%) but the investors will have a level of influence
- 'Stages' of equity investment
 - Friends and family
 - Seed funding (angels / high net worth individuals)
 - Series A onwards (institutional investors, different classes of shares)
- First stage of any investment? Term sheets

What is a Term Sheet?

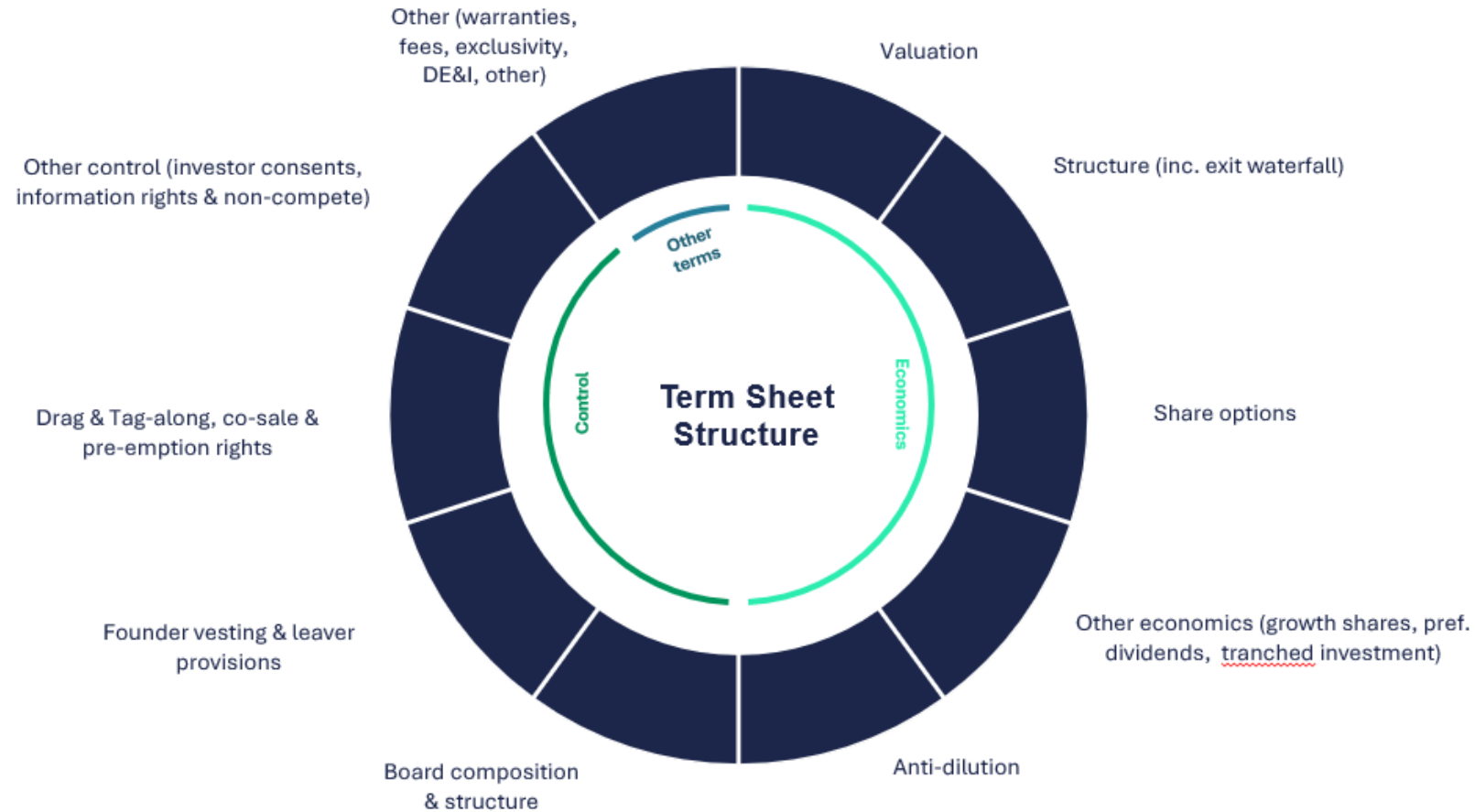
- Term sheet received by the company from investors prior to a proposed investment (hopefully multiple!)
- Typically the (non-binding) basis for the negotiation of long form documents (which can take 4-6 weeks + to agree) – but the company should also instruct lawyers when a term sheet is received

Term sheets consist of 2 components:

1. Economics of the deal

2. Control

'Economics and Control'



Investment Documents – Articles and Shareholders' Agreements

Vital documents to ensure smooth management of the company. Important in governing the company's operations and resolving disputes.

- **Articles of Association:**
- The company's constitution, internal rules, and regulations (publicly available).
- Typically new companies will have 'model articles' which are off-the-shelf

- **Shareholders' Agreements:**
- Outlines the relationships between the company and its various stakeholders - normally the founders and the investors.
- Not all companies have shareholders' agreements

It's never too early to have bespoke documents and solutions – plenty of cheap online services available for early stages e.g. seedlegals and Vested. As an example, founder 'fall outs' are common where the relationship is not formalised which can have expensive consequences.

Shareholder disputes are common

➤ Facebook (now Meta Platforms, Inc.)

As seen in the Social Network movie, early co-founder Eduardo Saverin was involved in a dispute around his ownership of shares and dilution of Saverin's stake

➤ Snap Inc. (Snapchat)

Snapchat co-founders had a dispute over the ownership of the company. Reggie Brown claimed he was a co-founder and entitled to a significant share of the company. This dispute resulted in a settlement where Brown received a confidential cash settlement.

➤ Twitter

Twitter faced a lawsuit from its early investor who alleged that Twitter's co-founders and investors had conspired to dilute his shares in the company. This dispute was eventually resolved, and the terms were not publicly disclosed.

➤ Pinterest

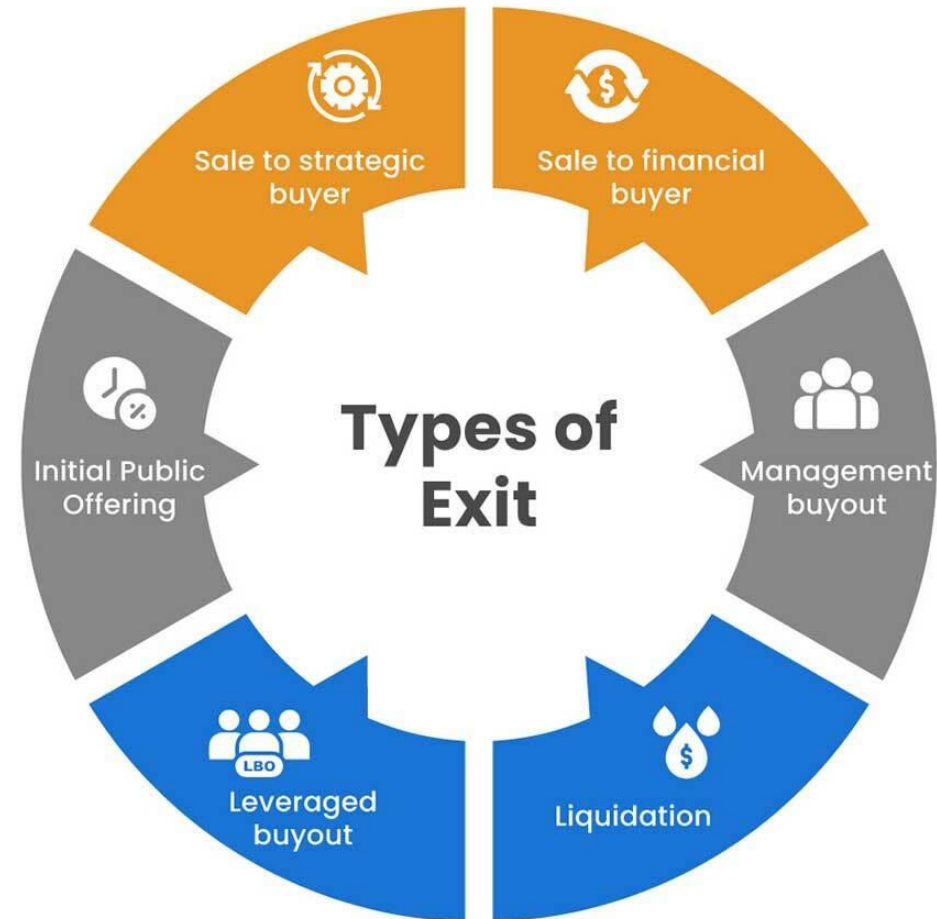
Pinterest faced a lawsuit from a co-founder who claimed he was unfairly pushed out of the company and had his ownership stake diluted. The lawsuit was settled, with terms not publicly disclosed.

➤ Zynga

Zynga, the social gaming company, faced a lawsuit from one of its former employees, Alan Patmore, who was the general manager of the popular game "CityVille." Patmore claimed that Zynga had promised him stock options, which were not granted as agreed. Zynga countersued, and the dispute was settled out of court.

Exits

- Exit strategies: Selling the shares in the company to a buyer – or even an IPO
- The ultimate aim of many early-stage businesses
- If an exit is your desired outcome, you should be preparing for this from Day 1 as a 'buyer' will carry out due diligence on everything the company has ever done or entered into – be prepared!



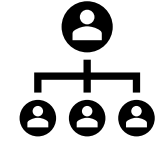
Common pitfalls

Finally, we wanted to flag some of the most common pitfalls we see:

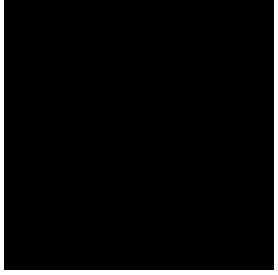
- Lack of preparedness for investment / exits – not keeping on top of filings, cap table etc
- Taxation – issuing shares to employees without considering tax consequences
- Employees – engaging 'contractors' who are really employees in all but name
- Lack of protection of IP – e.g. using freelancers to write code and not properly assigning it

We see these all the time and they cause massive issues!

Key Takeaways



- Think carefully about setting up your business structure – but don't put it off if you're growing fast.
- Admin is boring but important – if you keep accurate records and registers, it will save you time, money and stress in the long run!
- Director/shareholders must understand their roles and requirements
- Appointing advisors is expensive but necessary – do it yourself, but know where your limits are.
- If you're looking to fundraising, instruct a lawyer **before** signing a term sheet.



Any questions?



Thank you

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