CANDELP

COMMERCIAL & ENERGY LAW PRACTICE

LEGAL ISSUES *in* STARTUP FINANCING

by Funmilayo Akinpelumi

Starting a business is never an easy task as there are various hurdles to cross when starting a business. These challenges span across choosing the right financing option for the business given the financial and legal implications of the various financing options as well as how best to secure the interests of the founders and grow the business to a viable stage.

This article identifies the different types of financing options, their pros and cons as well as the legal issues to be considered when sourcing for financing.

What is Startup Financing?

Start up financing is basically the strategy adopted to fund a business from the start. Startup financing is majorly of two types- equity financing and debt financing.

Equity Financing

Equity financing is the issuance of stakes (stocks) in a startup business such as shares, in exchange for some form of value which could be money, services, facilities etc. Only companies can adopt equity-based financing.

One effect of equity-based financing is that it dilutes the control of the company. Thus, founders of a company who intend to retain complete ownership of the company should be mindful of the equity being conceded in exchange for funding. An example of a company that utilized equity financing is Dropbox, a cloud-based file storage and collaboration platform. Dropbox utilized equity and venture debt financing to support its product development and user acquisition efforts in its early stages.

Types of Equity financing?

1. Common Stocks

Common stocks, also referred to as ordinary stocks or shares, confer on the holder of such stock certain benefits in the company. A common shareholder can contribute to the decision-making process of a company as they have voting rights. A downside of holding a common stock is that in the event of a liquidation of the company, the creditors of the company take precedence over the shareholders as the company is obligated to settle the debt owed to the creditors first.

Preference shareholders also take precedence over the common shareholders with respect to the payment of dividends.

2. Preferred stocks

Holders of preferred stocks or shares are given priority over ordinary shareholders with respect to dividend payment as earlier stated. They, however, have no voting rights unlike the common shareholders. Thus, where an investor seeks to participate in the decision making of a company, common shares will be preferred but where the investor is more concerned with his return on investment (ROI), preference shares are a better option. The ROI is however dependent on the profitability of the company as dividends are only paid when a business declares profit.

Equity financing can be sourced from the following:

- Private Equity Firms (PEF)

These are firms which invest in companies in exchange for equity. PEFs are highly skilled in private equity investments and adopt several strategies when investing in a company. Some examples of PEFs are investment banks and venture capitalists. Venture capitalists however streamline their investments to businesses in an industry that is gaining traction in the market, e.g. tech companies. Companies like Google, Amazon and Apple have utilized venture capitalists to secure financing in the past.

- Equity Based Crowdfunding

This entails sourcing funds from many individuals publicly in exchange for equity. The share of equity conceded is dependent on the sum invested.

In Nigeria, the Securities and Exchange Commission (SEC) regulates crowdfunding. Only Micro, Small and Medium (MSMEs) companies registered in Nigeria with a minimum of two years' operating track record or with less than two (2) years operating track record but which have strong technical partners possessing a minimum of two (2) years' operating track record or have a core investor are eligible to carry out equity-based crowdfunding. MSMEs are companies with 199 employees or less with an asset base of less than 500 million naira.

- Initial Public Offering

This is a process where a company offers its shares to the public to subscribe. Only public companies are permitted to carry out IPOs in Nigeria. The SEC regulates strictly the procedure for carrying out IPOs in Nigeria, providing that companies carrying out IPOs are required to have a prospectus providing comprehensive details in respect of such offering.

IPOs differ from crowdfunding as the latter is usually carried out at the initial stage of a business while the former is carried out at a later stage of the business especially where the business is seeking to expand.

Also, in Nigeria, IPOs are exclusive to public companies listed on a recognized stock exchange. Crowdfunding is however open to both public and private companies provided they are MSMEs. Additionally, crowdfunding is a much easier means to source funds than IPOs as it can be performed through a few clicks on a crowdfunding portal. The process of an IPO is rigorous.

- Institutional Investors

These are institutions which invest their funds in exchange for either equity or debt of a company. Some examples of institutional investors are pension and insurance companies.

- Private Placement

This involves reaching out to private individuals to take up equity in a company in exchange for financing. This is usually employed where the company intends to vest its ownership on a specific group of individuals. This may be due to various reasons such as protecting the image of the company and ensuring smooth corporate governance.

- Angel Investors

These are individuals (usually of high net worth), who invest in businesses. Other investors include family, friends etc.

Debt Financing?

Debt financing entails funding a business through debt. Individuals or institutions (creditors), loan businesses money which is to be repaid with interest at a certain time and under certain conditions. Debt financing may be adopted where the founders of a business do not intend to dilute the ownership of the business as no equity in the business is conceded in exchange for the loan.

On the other hand, where an investor has interest in a business with a high success potential, the investor might want to have a stake in the business and participate in the decision making of the business. In such an instance, equity financing, precisely common shareholding, is the best alternative.

Debt financers (creditors) often take priority over equity financers (shareholders) as their loans and interests are required to be repaid before the entitlements of the shareholders are met.

There are different types of debt financing instruments depending on the nature of interest sought to be held by an investor. They are:

1. Debentures

These are certificates issued to creditors of a company, evidencing the company's indebtedness to the creditor. Debentures may be secured with assets of the company (secured debentures) or may be unsecured.

2. Convertible bonds/notes

These are instruments issued by a company to creditors which confer a right on the creditors to convert their loans to equity in the company at a certain stage and subject to the creditor's compliance with certain terms.

3. Debt Financing Agreements/ Loan Agreements

These are agreements which evidence a business's indebtedness to a creditor. It also provides terms which regulate the relationship between the business and the creditor.

Debt financing may be sourced from the following:

- Venture debt lenders

These are institutions that specialize in providing venture debt to start ups and companies in general e.g. venture capital firms. Venture debt financing is a type of loan provided to start ups and growth stage companies in an industry with high growth potential such as tech and biotech companies.

The debt is often used for the purchase of equipment, financing of working capital, research and development funding and expansion operations. Venture debt lenders are more focused on the growth potential of a company and provide flexible repayment terms which align with the company's growth and cash flow unlike traditional lenders.

In view of the focus of the venture lenders on the growth of the company as well as the flexible repayment terms provided, the interest rates of venture debts are often higher than traditional debts to compensate for the risk undertaken by the venture debt lenders.

A few examples of companies that have utilized debt financing to scale their operations are Spotify and Coursera. Spotify utilized venture debt to accelerate its global expansion and Coursera utilized venture debt financing to expand its educational offerings to reach a wider audience.

- Debt Crowdfunding

This entails sourcing funds from many individuals publicly to be repaid with interest. The interest to be paid is dependent on the amount loaned. The mode of obtaining debt crowdfunding is seamless like all crowdfunding operations as it can be performed via an online portal. This is also regulated by the SEC rules.

- Institutional Investors

As earlier discussed they include pension and insurance companies.

- Angel Investors

Include high net worth, family and friends.

Legal Considerations in Startup Financing

There are various legalities to consider when choosing a financing option (debt or equity), these legalities include the appropriate legal structure to adopt and necessary Agreements setting out the rights and liabilities of the business owners and investors. These considerations are discussed below.

An unlimited liability company, however, does not provide this security. Thus, in the event of a wind up, the personal assets of the shareholders of the company may be affected where the company is unable to settle its liabilities.

The business objective of a startup also determines the business structure to be adopted. For instance, in Nigeria, businesses for the provision of banking services are required to be incorporated as companies.

- ## Legal structure of the business

The legal structure adopted by a startup determines the financing option that may be adopted by the business. For instance, only registered companies can adopt equity financing. Business names cannot adopt equity-based financing due to their structure.

The legal structure also determines the extent of liability of the owners/shareholders. For instance, a limited liability company restricts the liability of the shareholders to the amount of their unpaid shares in the company. Thus, if the company is being wound up, their personal assets will not be affected, and they will only be liable to the extent of their unpaid shares in the company.

- ## Neccessary agreements

1. <u>Shareholders' Agreement:</u>

This sets out the shareholding of each shareholder and their rights and liabilities. This Agreement also provides the procedure for the transfer of the shares and other terms which regulate such transfer. For instance, Shareholders' Agreements provide pre-emptive rights for shareholders such that in the event a shareholder intends to transfer its shares, the exiting shareholder is required to offer its shares to the existing shareholders for purchase first before such shares may be offered to third parties. This provision helps control the dilution of the company.

2. Creditors' Agreements:

This regulates the relationship between the company and its creditors providing for the rights and liabilities of the creditors and the company such as creditors' charges over the assets of the company (where the loan is secured), the interest rate of the loan and maturity date for repayment etc. An example of a Creditors'

Carrying out thorough review of agreements.

The various agreements entered in the process of sourcing financing for startups must be reviewed critically and thoroughly to ensure that the interests of the founders are protected, and their risks minimized to the barest minimum.

There are certain terms to look out for under these agreements. A few of them include:

and the high risk borne by them in financing the startup company at its early stage. It is wise for founders to kick back against these provisions to secure their interests in the company where they are the minority shareholders. This can be done by a total kick back against such provisions or an infusion of certain provisions to curb the exercise of this right.

Some provisions that may aid in curbing this provision include setting a time frame within which the drag along right may be exercised. This will give the minority shareholders some time to maintain their shareholding in the company.

Another measure that may be taken is to increase the number of majority shareholders that may trigger the drag along right. For instance, where the founders are the minority shareholders, they may propose that the right can only be exercised by two-thirds or three quarters of the majority shareholders and not a simple majority.

1. Drag Along & Tag Along Rights

Drag-along rights are commonly found in venture capital agreements. These are rights which are conferred on majority shareholders of a company authorizing the majority shareholders to compel the minority shareholders to sell their shares on the same terms as the majority shareholders in the event the majority shareholders seek to sell off their shares in a company.

These rights are usually beneficial to the venture capitalists who are usually the majority shareholders in a company given their huge investments in the company

The founders may also propose board approval for any proposed sale of shares and stipulate a minimum price for the sale.

Founders may also protect their interests by incorporating tag along rights into the venture capital agreement. A tag along right confers a right on minority shareholders of a company to negotiate the terms for the sale of their shares in the event of a sale of the company as opposed to drag along rights where minority shareholders are compelled to sell their shares on the same terms as the majority shareholders. Thus, tag along rights afford the opportunity to refuse a sale thereby maintaining the equity held in a company.

2. Restrictive Covenants - Exclusivity Clauses or No Shop Clauses

These are clauses that may be incorporated by investors into investor agreements that restrict a start up from sourcing financing from other investors. This is usually incorporated to limit the startup's liability thereby securing the investor's interest and conferring on the investor a great deal of control over the start up.

Startups should be on the lookout for such clauses and negotiate them smartly to prevent situations where the startup will be locked up with an investor without recourse to other sources of financing. A tip on this may be to leverage the potential scalability of the startup to negotiate a short duration for an exclusivity clause as startups with highly scalable potential find it easier to access financing.

Other restrictive covenants that may be infused into debt agreements to protect an investor's interest include financial performance targets and restrictions on operational activities.

Financial performance targets are milestones set by investors for companies to attain within a certain time frame. This is done to ensure that the company is viable and able to satisfy its financial obligations. Investors may also restrict a company's activities/operations to reduce its risk and secure focus on its business objective, which can minimize the investor's risk. Startups should negotiate such clauses with their investors smartly to prevent being bound by stringent clauses.

3. Terms of Convertible Loan Notes

As highlighted earlier, convertible loan notes (CLN), are a type of debt financing. There are certain provisions in CLN that require special attention from both the investor and startup, as these provisions have serious implications. One such provision is a valuation cap.

A valuation cap is the maximum amount for which a startup may be valued. This provision is usually inserted in CLNs to protect investors as it provides a bit of certainty on the equity that may be held by an investor in the event of a conversion of the debt to equity as the lower the valuation of the company, the higher the equity of the investor in the startup.

Startup founders should be mindful of any provision that stifles their future value. They need to wisely negotiate clauses to reduce the stake of the investors and protect their interest and make available equity for future financing.

4. Discount and Interest Rates

A discount rate in a CLN is a reduction on the price for the sale of shares of a company granted to an investor if the investor seeks to convert its debt to equity in the company. A discount rate therefore creates room for an investor to acquire more shares in a company. Thus, where founders are particular about the ownership of a company, the discount rate offered to an investor should not be less. On the flip side, where the company has a high scalability prospect, it will be smart for an investor to push for high discount rates.

Interest rate is a profit on the loan advanced by an investor. CLN interest rates are usually low, however, the higher the interest rate, the more profitable it is to an investor as that would mean more return on investment (where the loan is not converted to equity), or more stake in the company (where the loan is converted to shares) because the interest rate increases the stake that can be bought in a company.

On the other hand, startups may want to curtail the interest rates on CLNs to minimize their liability (in the event the debt is repaid) or protect the interests of the founders and the company by not ceding too much equity to the investor.

4. Limitation of Liability of Founders

It is common to find certain provisions in agreements that confer joint liability on the founders of a company in the event of any breach or loss that may accrue to investors because of acts or omissions of any of the founders. It is safer for founders to ensure that their liability is several and not joint to prevent founders from being responsible for acts and omissions of other founders.

- Tax obligations of the startup

There are various taxes startups are required to pay. While some of these taxes apply irrespective of the sector in which a startup operates e.g. companies income tax, some are industry specific. For instance, telecommunication companies and financial institutions in Nigeria are required to pay Information Technology Tax.

Startups need to be aware of tax obligations and consider them when sourcing for financing as the tax obligations of a company may be likened to debt liabilities being incurred. Thus, where the tax obligations of a company are enormous, it may be safer for a startup to consider equity financing as opposed to debt financing to lighten the liabilities of the startup.

- Documentation of legal, financial and operational records

Legal, financial, and operational records are fundamental to startup financing. While carrying out due diligence, investors review these records to ascertain the scalability of a startup before investing. It is therefore necessary for startups to maintain updated records.

- Compliance with relevant laws

There are various laws which regulate start up financing in Nigeria. These laws include the Security and Exchange Commission (SEC) Rules on crowdfunding which regulate crowdfunding activities and Initial Public Offers (IPOs) as highlighted earlier in this article. Companies must comply with the applicable laws to avoid being penalized or sanctioned for non-compliance.

Conclusion

Having elaborated the intricacies involved in securing financing for a startup, it is imperative for founders and investors to strap their boots when sourcing for financing given the array of financial and legal considerations involved in financing.

It is also important to ensure that proper legal advice is sought to help startups meet their long-term objectives as well as secure the interest of investors.

References

1. *http://finance.yahoo.com/news/25-largest-vc-backed-companies-192418545.html*
2. *Securities and Exchange Commission Rules on Crowdfunding 2021*
3. *Small and Medium Enterprises Development Agency of Nigeria National Policy on Micro, Small and Medium Enterprises.*
4. *Small and Medium Enterprises Development Agency of Nigeria National Policy on Micro, Small and Medium Enterprises.*
5. *Section 22(5) of the Companies and Allied Matters Act 2020 and Section 67(1) of the Investment and Securities Act 2007*
6. *Securities And Exchange Commission Rules And Regulations, 2013*
7. *Section 67(1) of the Investment and Securities Act 2007*
8. *Rule 3 of the Securities and Exchange Commission Rules on Crowdfunding 2021*
9. *Understanding Venture Debt Financing by Davidson Oturu, L.L.M, MBA*
10. *Ibid*
11. *Securities and Exchange Commission Rules on Crowdfunding 2021*
12. *Section 2(1) of the Banks and Other Financial Institutions Act, 2020*

Funmilayo Akinpelumi
Associate
Funmilayo@candelp.com