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UNITED KINGDOM

## ***INTRODUCTION***

There are many ways to raise finance in the UK and there are no barriers for investors outside the UK who are interested in investing in UK companies, or for companies wishing to be listed on UK markets.

The type of financing which will be suitable will depend on the size, type, nature and objectives of the business in question. As far as general financing issues are concerned, potential investors should be aware of the broad regulatory framework which is outlined below.

In an article of this size, it is not possible to provide more than a very brief summary of what is available, and this is not intended to act as a substitute for proper and detailed advice which we will be happy to provide.

## THE REGULATORY FRAMEWORK

The regulatory and legal framework surrounding the raising of finance in the UK is a complex one. Care should be given at each stage of the process from the initial approach to potential investors through to the issue or publication of any offering documentation. The relevant restrictions are contained in a series of legislation and rules issued by regulatory bodies.

Central to this framework is the Financial Services and Markets Act 2000 (**FSMA**). **FSMA** goes to the heart of protecting the investor by regulating when and how companies may approach potential investors and ensuring that the information provided by parties seeking to raise funds is accurate and not misleading.

One of the key **FSMA** provisions stipulates that a company wishing to raise finance cannot, in any communication to potential investors, invite or induce them to buy shares or otherwise invest in a company unless it does so through an authorised person or an authorised person has approved the contents of the communication. An authorised person will usually be a securities house or bank authorised by the Financial Services Authority, the body enabled by FSMA in its various roles as regulator under the FSMA.

There are exceptions to this general rule intended to cover some of the most commonly accepted methods of raising finance from persons deemed not to require the full protection afforded by **FSMA**. These include communications made to 'business angels', investment and other professional firms, private equity firms, governments and, following a recent ruling, fund managers acting on behalf of individual clients if the discretion of investing lies with the fund manager. In addition, communications made to individuals or companies who are considered to have a high net worth and sophisticated investors under a regime of self certification can, if the conditions are met, be exempt. Whether or not a communication falls into an exemption will depend on whether the communication is 'real-time' (such as a personal visit or telephone conversation) or 'non real-time' (such as a letter or email), whether the real time communication is solicited or unsolicited and whether the person to whom the communication is made falls within the prescribed categories of persons set out in the **Financial Promotion Order**<sup>1</sup>.

Another provision central to the protection afforded by **FSMA** is that it is an offence to make any statement which is false or misleading where such a statement is designed to persuade people to enter into an investment agreement or to buy or sell shares in a company. This applies to statements made in any way or form, including statements contained in a business plan, any marketing materials or private placement memorandum.

Breach of the above or any other **FSMA** provisions can incur severe penalty including fines and, in some cases, imprisonment.

If a company which is raising finance is also seeking a listing of its shares it will have to comply with the relevant set of rules governing the market on which its shares are

to be listed. A company whose shares are or are to be listed on the Official List must adhere to the Listing Rules, the Prospectus Rules<sup>2</sup> and the Disclosure Rules as published from time to time by the UK Listing Authority (**UKLA**). If a company's shares are or are to be listed on the AIM Market of the London Stock Exchange (**AIM**) it must adhere to the AIM Rules and depending on how finance is to be raised, the Prospectus Rules, and if the company's shares are or are to be listed on PLUS then the PLUS rules for issuers and trading rules will apply as well as the Prospectus Rules in certain situations. These rules provide guidance on eligibility for listing through to requirements of the listing process itself and continuing obligations of a company once listed. The various rules prescribe the information which a company must give to potential investors and the standard of the information so given.

Finally, if the company raising finance is incorporated in the UK it will be subject to the Companies Act 1985. Provisions such as the prohibition of offering shares for sale to the public by private companies and the rules governing the authority of directors of a company to allot shares will be relevant as well as the rules of financial assistance and directors' dealings, to name but a few. The Companies Act 1985 is soon to receive a far reaching overhaul. The Companies Bill 2006 was published on 1 November 2005 and is currently awaiting its Royal Assent. It is expected that most of the provisions of this new legislation will take effect in October 2007.

# CONSIDERATION OF TYPES OF FINANCING

## 1. EXISTING SHAREHOLDERS AND DIRECTORS

Most early stage companies would look first for further funding from existing shareholders and directors. Additional shareholders may be brought in and it would be common to have in place a shareholders agreement and particular articles of association which are designed to provide protection to such investors and control who may hold shares. Such arrangements would not be generally dissimilar to a venture capital transaction, although it would be expected that they would be less complex and formal.

Where early stage companies are looking for further funding, care must be taken to comply with the financial promotions regime and the laws relating to prospectuses. Private companies, designated as “limited”, are not permitted to offer their shares to the public and care has to be taken that this is not the case.

## 2. GRANTS AND TAX BREAKS

### **Grants**

#### *Types*

Grants are sums of money which, once awarded, do not have to be repaid. There are a number of grants and awards from bodies such as the European Union, the Department of Trade and Industry, the National Lottery, etc. Other grants may be provided at a local level (such as subsidised rent and rates).

#### *Eligibility*

Grants are usually only available for specified projects and may not be easily available.

Eligibility for grants is usually assessed by reference to: (i) the location of the applicant's business (as special grants will be given to companies located in economically depressed areas, etc.); (ii) the industry in which the applicant's company operates (as special grants will be given to companies operating in certain sectors of industry deemed to be worthy of economic support (e.g., rural diversification, crafts, tourism, agriculture etc.)); (iii) the purpose or activities of the applicant's project (e.g., training and skills development, research and development, etc.); (iv) the size of the applicant's company (as the majority of government grants are only available to businesses of a certain minimum size); and (iv) employment opportunities (as some grants are intended to help new businesses and to boost employment).

### *Restrictions*

Grant schemes usually impose the following restrictions: (i) the project must not be under way already; (ii) the project must help towards achieving the objectives of the grant provider; and (iii) it should be shown that the project would not otherwise progress without the assistance of the grant. Additionally, most grants will require the applicant to invest in the project as the grants very rarely cover the entire cost of the project.

An applicant will most likely be required to submit together with its grant application, a proposal setting out: (i) a detailed project description; (ii) an explanation of the potential benefits the project offers; (iii) a detailed work plan (indicating who will do what and by when and including full costings); and (iv) details of the applicant's own relevant experience and track record.

### **Tax Incentives**

There are a number of tax advantages potentially available to individual investors relating to investments in unquoted companies. As summarised below, such tax reliefs include: business property relief for inheritance tax relief; corporate venturing tax incentive; venture capital trust schemes; tax credit for research and development investment; the Enterprise Investment Scheme; and capital gains tax business asset taper relief.

#### *Types of Tax Incentives*

##### **(i)** *Business Property Relief for Inheritance Tax (IHT)*

Shares held in certain unquoted companies are treated as "business property" and are exempt from inheritance tax, provided the relevant shares have been held for at least two years. Potential investors should obtain independent tax advice before investing in a company on the basis of business property relief for inheritance tax planning purposes due to the risks involved.

##### **(ii)** *Corporate Venturing Tax Incentive*

The corporate venturing tax incentive ("the CVTI") encourages large companies to invest in small high risk trading companies. The CVTI provides tax incentives for corporate equity investment in the same types of companies as those qualifying under the Enterprise Investment Scheme and Venture Capital Trust scheme. The incentives are available in respect of qualifying shares issued between 1 April 2000 and 31 March 2010.

The following tax reliefs are available under the corporate venture tax scheme:

investment relief - relief against corporation tax of up to 20% of the amount subscribed for full-risk ordinary shares, provided that the shares are held throughout a qualification period;

deferral relief - deferral of tax on chargeable gains arising on the disposal of shares on which investment relief has been obtained and not withdrawn in full,

if the gains are reinvested in new shares for which investment relief is obtained; and

loss relief - relief against income for capital losses arising on most disposals of shares on which investment relief has been obtained and not withdrawn in full, net of the investment relief remaining after the disposal.

**(iii)** *Venture Capital Trust Scheme*

Venture Capital Trusts (VCTs) are investment companies which invest in a portfolio of small UK trading companies. VCTs currently offer generous tax benefits to investors, currently, 40% of an investment of up to £200,000 put into new VCT shares (held for a minimum of three years) can be written off against income tax. However, from 6 April 2006, this will be reduced to 30% and there will be a requirement for the qualifying shares to be held for five years before the tax benefits under the scheme will apply. However, these changes will not apply to investments in VCTs entered into in 2005/06.

There are also a number of risks associated with VCTs which investors must consider before investing in a VCT.

**(iv)** *Tax Credit for Research and Development Investment*

Certain tax credits are available to companies engaged in certain qualifying research and development initiatives. The following qualify for tax purposes as research and development projects: (i) projects which seek to achieve an advance in science or technology; (ii) all the individual activities that directly contribute to achieving such advance in science or technology through the resolution of scientific or technological uncertainty; and (iii) certain indirect activities relating to a qualifying project. Activities other than qualifying indirect activities that do not directly contribute to the resolution of scientific or technological uncertainty in a project do not qualify as research and development projects for tax purposes. Costs qualifying for the tax credit include materials consumed or transformed, water and fuel (including electricity and gas); specially commissioned parts for prototypes; and software purchased specifically for the research and development project. Staffing costs also qualify, but benefits in kind provided to staff undertaking the research and development work are excluded. Small and medium-sized companies can obtain 50% enhancement on qualifying expenditure and large companies can obtain 25%. The claims process for tax credit claims and the enhanced deduction will now have to be made by the first anniversary of the filing date of the return.

**(v)** *Enterprise Investment Scheme ("EIS")*

EIS is a valuable incentive for individual investors. Through EIS, companies can raise money from individuals in each tax year by issuing ordinary shares in companies that are accepted by the Inland Revenue to be qualifying companies (i.e., broadly the company must be unquoted, that is, not listed on the official list of any recognised stock exchange (companies traded on PLUS and AIM are classed as unquoted for these purposes) and must be trading companies). Investors can claim tax relief at the rate of tax of 20% against their personal income. Investors can also gain further tax deferral at their higher rate, cur-

rently 40% by investing a sum equivalent to any chargeable gain on which they are taxable, in qualifying companies. Investors will not pay capital gains tax when they sell the shares as long as they keep them for three years, and provided the enterprise investment scheme has not been changed or cancelled. If the company goes into liquidation or is sold at less than cost, investors can claim relief for a net capital loss on their shares if reinvested in another qualifying company. Investors with no prior association with the company may become paid directors and may obtain tax relief on their investment. The amount individuals may invest in a tax year is £400,000 from 6 April 2006.

Certain qualification criteria must be satisfied before a company will qualify for EIS. Many trading companies will qualify for EIS, but the position should be confirmed by specialist tax advisers before potential investors are approached.

**(vi)** *Capital Gains Tax (CGT) Business Asset Taper Relief*

Even if EIS relief is not available (e.g., where shares are not subscribed for in a new issue but acquired in the market), tax relief may be available on the gain when the shares are sold. Taper relief reduces the chargeable gain on the sale of an asset based on the period for which the asset was held. The amount of relief available is determined by whether the investment is defined as a “business” or “non-business” asset under Inland Revenue Regulations. Shares in unquoted companies are considered “business assets” and therefore attract a significantly higher rate of relief.

For disposals of shares in unquoted trading companies, the percentage of the gain chargeable to tax is 50% for assets held for one year and 25% for assets held for two years or more. This means that after two years, a higher rate taxpayer would pay tax at 40% on 25% of the gain and the effective tax charge is 10%.

Also of note is that individuals are not liable to pay CGT if the total of their chargeable gains is less than the annual exemption (£8,800 with effect from 6 April 2006).

## 3. BANK FINANCE

Bank Finance is the most commonly used source of funding by businesses of all types and sizes. All businesses use banks for their day to day financial transactions and, because of the knowledge they are able to build up of their customers, banks are perceived as the obvious first port of call for basic finance.

The two main types of bank finance available are **overdrafts** and **term loans**, but there are a number of additional services offered by banks, including bridging finance; invoice discounting; hire purchase; and asset leasing.

### Suitability

An overdraft is a loan facility up to an agreed maximum which can be drawn on by the customer as and when needed. No cash is actually transferred to the customer – the bank allows the customer to become overdrawn on its account up to the amount of the facility. The amount of the overdraft will fluctuate as funds are received or paid out by the business. Overdraft facilities are designed to assist businesses with seasonal cash flow shortfalls, although they are often found to be a convenient (but expensive) way of providing effective long-term finance with the minimum of formality. The bank will normally make a one-off annual charge for agreeing to grant the facility and will also charge interest on a daily basis to the extent that the facility is used. An overdraft is not suitable as a means of providing long-term funding for two main reasons:

Interest rates for overdraft facilities are higher than for term loans;  
Overdrafts can be called in by the bank at any time.

Term loans are for a fixed term (normally 3-5 years, but often up to 10 years). Depending on the purpose for which the loan is made, it may be drawn in one or more tranches. As with overdrafts the bank will usually make a facility charge or charge a commitment fee as well as an interest charge. Interest can be either at a fixed rate or a variable or floating rate, but will normally be at a lower rate than is charged for overdrafts. Whilst an overdraft can only be provided by the bank with which the customer maintains its current account a term loan can be obtained from any bank.

A fixed term loan with a fixed rate of interest naturally provides an important element of certainty for a business owner. However, in an environment where interest rates are expected to fall in the medium to long term more and more businesses are attracted to variable rate loans, as they hope that the overall cost of borrowing will be lower. Interest rate swap arrangements may be available where it is considered that the wrong choice has been made.

### Ability to service debt

Of greater importance to a bank lender than **security** is the ability of a borrower to repay the loan and service the interest payments when due. The bank will expect to see a business plan showing how the finance is intended to be used and how sufficient profits will be generated to make payments due to the bank. The bank will need to understand the business and to be able to form a view as to the sufficiency of the requested

finance for the proposed project. Normally banks will expect there to have been professional involvement in the preparation of a business plan and financial projections.

### **Security**

However cautious the business plan may appear, all businesses are at risk from economic circumstances beyond their control and banks are always conscious of the fact that the business may make default as regards interest payments or repayment of capital. For this reason banks will in almost all cases require security. The taking of security enables the bank in case of default to sell the pledged assets, if necessary, to recover whatever may be owed to it.

Typically, security will comprise all or any of the following:

A mortgage or charge over real or leasehold property belonging to the company

A pledge of shares

A charge of book debts belonging to the company

A charge over machinery, equipment, or other assets of the company

A guarantee from another company or a director or shareholder, which may in turn be secured by a charge over that person's assets.

English law recognises the concept of a "floating charge" which is a device for giving the bank security over assets, such as stock in trade and bank balances, without restricting the company's ability to deal with and dispose of those assets as long as it remains solvent and is not in breach of the loan agreement. The most usual form of security required by a bank would be a fixed charge over land, buildings, machinery and equipment, and book debts, and a floating charge over all other assets.

### **Ongoing tests**

Banks require to be satisfied as to the financial health of the company and its ability to make payments under the loan agreement not only when deciding whether or not to make a loan, but throughout the term of the loan. The company will normally be required to make management accounts available to the bank on a monthly or quarterly basis and to satisfy tests of solvency, liquidity and capital adequacy which will be specified in the loan agreement. Failure to satisfy any of the tests at any time will constitute an event of default in which case any floating charge will crystallise and be automatically converted into a fixed charge and the loan will become due for immediate repayment.

### **Syndication**

In the case of very large bank loans, the bank with which the loan is originally negotiated (the "lead bank") may want to share the risk with other banks in what is known as a **syndicated loan**.

Normally the borrower, although aware that the loan is to be provided by a syndicate of banks, will deal only with the lead bank, which will contract both on its own behalf and as agent for the other members of the syndicate. The lead bank will enter into separate contractual arrangements with the other banks, and the borrower will not be a party to these. Generally, the obligations undertaken by the borrower will be the same as for any other loan.

## 4. HIRE PURCHASE AND LEASING

The acquisition of assets, particularly expensive capital equipment is a major commitment for any business, but particularly new businesses that are not yet established. The impact of this commitment can be reduced using hire purchase or leasing, so that rather than pay for the asset outright using cash, the cost can be spread, to coincide with the business generating revenue.

Under both hire purchase and leasing, the finance company retains legal ownership of the equipment, at least until the end of the agreement. This normally gives the finance company better security than lenders of other types of loan or overdraft facilities. The finance company may therefore be able to offer better terms.

### Hire Purchase

With a hire purchase agreement, payments for the full amount of the asset are made over a defined period. When all payments have been made, the business becomes the owner of the equipment. For the purposes of taxation, the business customer will always be treated as the owner of the equipment, allowing them to claim capital allowances (although start-up businesses may not always be able to make full use of these). The business customer will normally be responsible for maintenance of the equipment.

### Leasing

When equipment is leased, the fundamental difference from a hire purchase agreement is that ownership will never pass automatically to the business customer. Instead the leasing company will claim any capital allowances. These tax benefits will be passed to the business customer by way of reduced rental charges. In addition the business customer will generally be able to deduct the cost of lease rentals from taxable trading expenses. Again, the business customer will normally also be responsible for maintenance of the equipment.

Leasing arrangements come in two main forms:

- 1)** Finance leasing, an agreement structured so that the business customer pays the full value of the asset over a period plus interest. The business customer will be responsible for maintenance and insurance of the asset and must show the leased item on their balance sheet as a capital item. When the lease period ends, the leasing company will usually agree to a secondary agreement for a nominal fee. Alternatively, if the business wishes to stop using the equipment, it may be sold second-hand to an unrelated third party. The business arranges the sale on behalf of the leasing company and obtains the bulk of the sale proceeds.
- 2)** If a business needs equipment for a shorter time, then an operating lease or contract hire is preferable. The leasing company will expect to lease the equipment to many different customers over a period, or to sell it second hand and will therefore not expect to recover the cost of the equipment during the rental period. Assets financed in this way are not shown as assets on the balance sheet, the lease cost is treated as a cost in the profit and loss account.

## 5. TRADE FINANCE

### **Factoring**

Factoring allows companies to raise finance based on the value of their outstanding invoices. Factoring is a process whereby a factoring company (usually divisions within most commercial banks, divisions of large financial institutions or small to mid-sized independently owned companies) (“the Factor”) buys the trade debts of a company and pays the company a certain percentage (usually around 80%) of the value of such trade debt as evidenced by an invoice issued by the company. The payment by the Factor is made on receipt of a valid copy invoice from the company. The balance, less charges, is paid once the company’s customer pays the outstanding invoice.

#### *Criteria*

Generally, most Factors will require the following:

access to the books and accounts of the company so the Factor can perform an audit to confirm whether the company’s sales ledger meets its criteria (generally, companies must have a turnover of more than £200,000 to be considered for factoring; however, some Factors will consider start-ups with a turnover of £50,000 or less);

confirmation that the business has a number of customers (and no one debtor accounts for more than 25 to 40 per cent of the company’s business);

confirmation that the business is a trading business and offers its goods to its customers on credit terms (businesses which offer customers their standard credit terms are preferred); and

confirmation that the company is collecting its invoices within a reasonable time frame.

#### *The Factoring Process*

If required, the Factor will first agree with the company certain credit limits and how they will be handled. Once the company makes a sale, it must invoice its customer and send a copy of the invoice to the Factor. The Factor will then pay the company the agreed portion of the invoice value (usually 80%) within a pre-arranged time (usually within 24 hours). The Factor will then issue statements on the company’s behalf and will collect payments. The company will then receive the balance of the invoice (less charges) once the Factor receives payment. The Factor provides regular reports on the status of the company’s sales ledger.

#### *Types of Factoring Facilities*

##### **(i)** *Confidential and Disclosed Invoice Discounting*

Invoice discounting allows a company to retain control of its own sales ledger

operations. With invoice discounting, a company can collect its own debts. There are two types of invoice discounting, confidential and disclosed (i.e., non-confidential).

Where confidential invoice discounting is used, the customer will not be made aware that the company is using an invoice discounter as the company will send out its invoices and statements as usual. In contrast, where the invoice discounting is disclosed, the customer will be notified and informed that the company is using an invoice discounter.

In respect of both confidential and disclosed invoicing, the invoice discounter will make an agreed portion of the value of the invoice available to the company once it receives a copy of the invoice the company has sent to its customer. Once the company receives payment, it must deposit the funds in a bank account controlled by the invoice discounter. The invoice discounter will then pay the company the balance of the invoice, less any charges once the funds have been remitted into the Factor's own bank account.

**(ii)** *Recourse Factoring*

Recourse factoring is similar to disclosed invoice discounting, however the Factor is responsible for the administration of the company's sales ledger and the chasing and collecting of overdue accounts for payment. Recourse factoring is the most common form of factoring arrangement and by outsourcing this function it can free-up a company's valuable management time. The word 'recourse' means that if the customer fails to pay the invoice after a set period of time the Factor will require any funding provided against that invoice to be repaid by its client – normally recovered from later invoices.

**(iii)** *Non-Recourse Factoring*

Non-recourse factoring is similar to recourse factoring, except with non-recourse factoring, the Factor provides bad debt protection. This is normally based on limits set by the Factor per customer dependent on the credit worthiness of that customer.

**(iv)** *Maturity Factoring*

Maturity factoring works on the basis of the Factor guaranteeing to make full payment of an invoice after a set number of days from the date of the invoice regardless of whether the customer has paid or not. The main benefit of this type of facility is in cashflow planning, as a company will know exactly when it is going to be paid.

**(v)** *International Factoring*

Some Factors offer an international facility for the collection of debts abroad. They will make use of an associated factoring company based in the respective country of a company's customers who will be responsible for the collection of payment which they will remit back to the UK Factor.

### *Criteria*

The suitability requirements for invoice discounting are more stringent than those in respect of factoring. Typically, in respect of confidential invoice discounting, an invoice discounter will require: (i) confirmation that a company's annual turnover is over £500,000; (ii) access to the company's books so the invoice discounter can regularly audit the books to confirm that the company's credit control procedures are adequate; and (iii) confirmation that the company is profitable and has a minimum net worth of £30,000.

The suitability requirements for disclosed invoice discounting are generally less demanding than those in respect of confidential invoice discounting.

### *Advantages*

Factoring and invoice discounting allow businesses to maximise cashflow. Factoring reduces the time and money a business spends on debt collections and can assist businesses in assessing the creditworthiness of its new and existing customers.

### *Disadvantages*

A Factor will usually take over the maintenance of a company's sales ledger and may impose constraints on the way the company conducts its business. A company may only require from the discounter, the finance arrangements, but most often will be required to pay for and utilise the Factor's collection services as well. Also, the company's customers may prefer dealing with the company directly in respect of invoices and collections, rather than a Factor. Finally, ending a factoring arrangement can be difficult and may prove time consuming and costly.

### **Letters of Credit**

Letters of credit are issued by a bank on behalf of the importer ("the buyer") and conditionally guarantee payment to the exporter ("the seller") provided the documentation submitted by the seller complies with all conditions specified in the letter of credit.

There are two types of letters of credit. An import letter of credit is one issued on behalf of the buyer. An export letter of credit is one that the bank has received from another bank in favour of the seller.

### *Key Features*

Letters of credit are: (i) subject to the globally recognised International Chamber of Commerce Uniform Customs and Practice for Letters of Credit; (ii) normally irrevocable (i.e., a definite undertaking which cannot be revoked without the agreement of all parties); and (iii) can be initiated electronically.

### *Advantages*

Letters of credit can be the safest and fastest method of obtaining payment (other than payment in advance) and can provide reassurance that the seller will get paid, provided their documents are strictly in accordance with the terms and conditions set out in the letter of credit. Additionally, letters of credit allow the buyer to do business with trading partners who insist on letters of credit being in place before they will agree to trade. Further, letters of credit allow the buyer and seller to enter into trading agreements where open account trading would not be suitable.

### *Disadvantages*

The arrangement and administration fees in respect of letters of credit can be substantial; however these are often subject to negotiation.

## 6. BUSINESS ANGELS AND OTHER PRIVATE INVESTORS

This is essentially a development of the points made under 1 above. Where a company is seeking additional funding on a fairly small-scale, it is common to involve so-called “business angels” who are able and willing to invest relatively small sums into such companies. There are lists maintained of certain “business angels” and it would be expected that as a condition of investing, the existing management would provide the investors with detailed information and provide warranties in relation to the same. It would also be usual for there to be in place a shareholders agreement containing various protections for the benefit of the “business angel”.

As mentioned above, care must be taken by any company seeking such finance to comply with the relevant law relating to financial promotions and offers to the public.

## 7. VENTURE CAPITAL

### **Introduction and Suitability**

Venture capital is a term used to describe a range of investment structures where the investing institution acquires a share in the business. The form of investment may take the form of equity capital only, a mixture of equity capital and preference shares, or a mixture including an element of debt. Traditionally, venture capital had been regarded as suitable for start-up situations and development capital for more mature organisations. However, venture capital transactions have become increasingly large in the UK and are less frequently a source of finance for the average small to medium sized company. There are a number of different venture capital funds in the UK of which some have a preference to invest in certain types of industrial sectors. Venture capital organisations are now often brought in to help finance buy-ins and buy-outs of substantial companies. This follows an increasingly popular trend for some public companies to be taken private.

Venture capital denotes a certain element of risk and the venture capital investor will have an interest in the business and its success quite different from that of a bank providing simple debt. The return is dependent on the growth and profitability of the business and will be provided to the venture capital investor when it is able to sell its shareholding when the business is sold through a trade sale or a flotation (“IPO”). Accordingly, the ability to exit from the investment will be an integral part of the documentation and is usually provided over a target three to five year period. By definition, investments in early stage companies and those, the nature of the business of which requires a long development lead time, are often less attractive than more mature businesses to venture capital providers highlighting once more the shift to bigger transactions.

Also worthy of mention are venture capital trusts (VCTs) which are listed companies which have as their objective to encourage investment in smaller unlisted (unquoted and AIM quoted companies) UK companies by offering private investors tax incentives in return for a five year investment commitment. For investors to be able to receive the tax benefits of investing in a VCT, there are certain conditions that have to be met and restrictions regarding the company’s activities within the first few years. There is a similar scheme in place known as EIS or enterprise investment scheme, which provides similar tax breaks in return for investing in small high-risk companies.

### **Structure**

Before making an investment, a venture capital provider will wish to review the business plan and conduct financial and legal due diligence on the company. There will then be detailed negotiation of an investment agreement and there will also be a number of ancillary documents which need to be settled. The nature of these will depend on the exact structure of the investment to be made and what other agreements need to be put in place, e.g. service agreements for directors. The structure will also depend on the type of investment and equity venture capital investors may invest in one or more classes of share. Some part of the investment is likely to be in equity shares, perhaps with special rights over and above those of the holders of ordinary shares, or non-equity preference shares, which will rank ahead of all classes of ordinary shares for both income and capital, but once their entitlement has been paid they would have no further right to share in the profits or capital of the company. They may be expressed to be convertible into equity shares in certain circumstances and it is also common to provide that there are incentives for good performance which result in the shareholding of the venture capital investor being reduced as appropriate. This type of structure is commonly known as a ratchet as it permits the interests of the participants to be adjusted according to performance. Debt Investment in the company can also be made by way of loan capital, usually in addition to an equity investment, and this may be in secured or unsecured form. A secured loan will rank ahead of unsecured loans and some other creditors of the company before shareholders. In some cases loan capital may be convertible into equity shares and there may be provision for the issue of warrants or options which entitle the holder to subscribe for a certain number of equity shares on the terms specified in the documentation. These sort of arrangements are regarded as equity incentives to reward the investor if the company performs well. Because of the higher risk involved, these type of investments would

typically carry a higher rate of interest than bank term loans and also rank behind the bank for payment of interest and repayment of capital.

It is common for venture capital investment to be accompanied by additional debt financing and financing structures which include both an element of equity and debt are usual. There may be a provider of debt which is classified as senior on the basis that it will be subject to a first charge on the company's assets and therefore rank ahead of any other of the company's liabilities in priority of payment. There may also be an element of mezzanine financing where there is additional loan finance provided which is classified as halfway between equity and secured debt. Mezzanine finance would either be subject to a second charge on the company's assets or be unsecured. Because the risk is considerably higher than that for senior debt, the interest charged will be higher, again, because of the risk, and it would not be unusual for the mezzanine finance to include an element of warrants or options to subscribe for shares in the company.

## **Exits**

As mentioned above, it would be vital that in any venture capital investment, there is an end date, typically of between 3 to 5 years and few venture capitalists will be interested in a time horizon beyond that. Accordingly, mature revenue producing companies are more likely to be of interest than those which indicate a long time line to profitability.

## **Rights of Venture Capital Investor**

It should be noted that as part of the investment agreement, it would be usual for the venture capital investor to seek a degree of control over the company, although care is needed that this is not too extensive. The venture capitalist's rights will typically include the right to receive information, a right of veto in relation to any major activity, restrictions on issues and transfers of shares, restrictive covenants and a right to nominate a representative to the board. In addition the investor would typically have additional rights if there are any problems meeting commitments to the investors. These may include the right to receive a greater proportion of the shares and the right to determine whether the company is to continue in business or is liquidated. The degree of overall control which needs to be relinquished by the founders may vary on a case by case basis, but this is characteristic of venture capital transactions. Accordingly, some founders may find this a less attractive way to proceed than some other options, although for a company generating the necessary revenues and experiencing a good level of growth, the benefits of such financing can, nevertheless be very beneficial.

## 8. FLOTATIONS/IPOs

### **Suitability**

Any proposal to list a company on a public market will need to take into account the suitability or otherwise of the vehicle. Although it is possible to list companies on some markets which do not have a particular track record or financial history, an assessment will need to be made by any financial adviser as to whether public funding is appropriate. In any event, before a flotation, a company must have suitable systems and procedures in place which indicate that it is suitable for the public market.

### **Processes**

It is usual for a certain degree of restructuring to be effected before a company is floated and this will be as advised by the company's financial and other advisers.

The process of flotation will then involve the production of a marketing document containing certain information on the issuer, its directors, business activities and financial position. The exact nature of this document will depend on the rules of the market on which listing is sought and also on the method of fund-raising.

In the UK, it is more usual for fund-raising to be made by way of private placings with institutions rather than by way of an offer to the public. Often this will be affected by way of a pathfinder document which is provided only to institutions who have expressed an interest in the company. Depending on the degree of interest, the share price and the number of shares to be issued will be decided at the last minute and the final document published and application made for listing.

### **AIM**

AIM has been and continues to be a great success story and most companies seeking a listing in the UK now choose to do so on AIM. It is not for nothing that the London Stock Exchange describes AIM as the most successful growth market in the world and the leading market for smaller growing companies from all over the world, and boasts that over 2,000 companies have joined AIM since its launch in 1995. Further information on AIM can be found on the London Stock Exchange's website at <http://www.londonstockexchange.com/en-gb/>

AIM is a junior market which is less regulated than the Official List. The registration is largely effected by the financial or nominated adviser (commonly known as the "NOMAD") and the company's other advisers. The documentation required for an admission to AIM is essentially the same as for a prospectus with, however, the big difference that the document, since it is not technically a prospectus if the funds are raised by way of private placing with institutional investors, will not need to be reviewed and approved first by the Financial Services Authority. Where AIM companies wish to make an offer to the public then the Prospectus Rules will apply and the document might be required to be approved before publication by the UK Listing Authority.

Stricter rules have now come into force so that where a company is merely a cash shell, it must raise more than £3 million, otherwise there are no real limitations on the type of company which may be listed on AIM as long as it is otherwise suitable, (suitability being judged to a large extent by the relevant NOMAD).

### **Official List**

The senior market of the London Stock Exchange is known as the Official List and companies so listed are subject to an extra tier of regulation by the UK Listing Authority, which is part of the Financial Services Authority. Where greater visibility is required for large companies, the Official List is likely to be a preferable route to the public markets. However, this will mean a greater degree of regulation and on-going compliance than would be the case for AIM companies. More information on the Official List can be found at <http://www.fsa.gov.uk/>

### **PLUS MARKETS GROUP (formerly OFEX)**

PLUS is an independent UK provider of primary and secondary equity market services. It is a public market which is designed for small and medium enterprises. Strictly speaking, companies whose shares are traded on PLUS are unlike both the Official List and AIM, not listed or quoted and PLUS operates as a trading facility. The PLUS market (in its previous name, OFEX) was established in 1995 and over 800 companies have their shares traded on PLUS. It is broadly intended for smaller companies that might join AIM at some stage in the future and can also provide a trading facility for family companies where some liquidity in the shares is required.

Companies wishing to join PLUS must comply with the PLUS Rules (which comprise the Rules for Issuers and Corporate Advisers and the Trading Rules) as well as general legislation including the Financial Services and Markets Act 2000. The PLUS Rules include a number of admission requirements to PLUS, as well as continuing obligations. More information on PLUS can be found on its website at <http://www.plusmarketsgroup.com/>

### **Unquoted Offer to the Public**

With the implementation of the new rules on prospectuses, it is less attractive for companies to make public offerings without also seeking admission to one of the public markets. Although the information requirements under the Prospectus Rules are a little different from the previous law, there is the added complication of the requirement to obtain the approval of the UKLA, which adds to the costs and complexity of the issue.

There may however be circumstances in which companies wish to raise finance without looking for a public market and this has been commonly used in certain types of fund-raising, e.g. specialised film companies.

Although there are a limited number of exemptions to the requirements to produce a prospectus, it seems likely that the general rule, where an offer to the public is made, is that a prospectus will be required of a public company.

## Placings

As indicated above, it is common for fund-raising to be made by way of private placings with certain qualified investors in compliance with legislation and the regulations and the rules of the relevant market. Where funds are raised from a small number of professional investors the regulatory requirements are generally easier to comply with and accordingly, this tends to be the preferred mechanism for equity financings in the UK, both for primary and secondary issues.

## Pre-IPO Finance

It is often the case that companies which seek to be quoted on an investment exchange and to raise finance on flotation will need short-term finance prior to their IPO. There is no particular set format for such finance and can be one or a combination of methods of finance. Generally, the more risk associated with the investment the greater the “cost” to the company (whether this is measured in purely financial terms or in terms of the dilution of existing shareholders). Most investors will assess risk by considering what would happen if the company became insolvent. Under English law, the assets of the company would be used to pay: secured creditors first; unsecured creditors second; and shareholders third, who (if there is more than one class of share in the company) would be paid according to the respective rights of the different classes of shares set out in the company’s articles of association).

The most risky form of pre-IPO finance is therefore generally considered to be a subscription for shares, and so the subscription price is likely to be significantly less than the likely flotation price so as to take into account the added risk of subscribing for shares in an unquoted company.

For the same reason, the subscription for convertible or non-convertible loan stock will be a slightly less risky form of pre-IPO finance from the point of view of the investor i.e. the investor will, as a creditor, rank higher than a shareholder on any return of assets. Clearly, an investor can obtain even more comfort about the certainty of being repaid if the loan stock is secured over the assets of the company. However, the company may not be in a position to provide security if the assets of the company are already secured, or it may only be able to provide a second or third ranking charge, which might be of limited value.

The issue of convertible loan stock allows the investor to have the advantage of being a creditor until the date of flotation and to participate in the benefits of being a shareholder in a quoted company when the financial future of the company is more certain. Convertible loan stock issued in a pre-IPO financing is often drafted on the basis that the company can acquire conversion on flotation. The conversion price is usually expressed to be at the flotation price, but is some time at a discount to the flotation price.

A further way of recognising that a pre-IPO investor is making a relatively risky investment is for the investor to be issued a new, more advantageous class of shares. For example, a pre-IPO investor might be issued preference shares that carry the right to be paid a fixed sum on a return of capital before any sums are paid to the holders of ordinary shares and/or for the right to receive a fixed dividend on specified dates.

It is also quite common for all of the above forms of pre-IPO finance to be issued together with warrants or options which give the holders of such warrants or options

the right to subscribe for shares in the company at a fixed price for a specified period of time. The logic is that, by the time the warrants or options are exercised, the share price is likely to be substantially higher than the exercise price and so the holder of those warrants or options can sell the shares immediately on exercise and realise a profit. The difference between warrants and options is that warrants are generally transferable and options are generally non transferable.

## Ongoing Obligations

The rules for the main investment exchanges in the United Kingdom (i.e. the Official List, AIM and PLUS) are all slightly different. However, there are two main themes running through the rules of all the UK investment exchanges in relation to the continuing obligations of companies admitted to trading on those exchanges. First, there is the principle that there should be “an even playing field” for all investors in a company quoted on an investment exchange. Secondly, there is the principle that certain events require shareholder approval.

The concept of all investors playing on an even field is underpinned by the principle that all shareholders should have the same information about the quoted company on which they can make their investment decisions. Clearly, there would be the opportunity for one person to have an unfair advantage over another if he knew information about the company that the second person did not know. All investment exchanges therefore have rules about timely announcement, on the relevant regulatory information service, of unpublished price-sensitive information. As well as there being the general requirement to announce unpublished price sensitive information, there are usually specific requirements to announce events which are likely to be price-sensitive, e.g. the appointment or dismissal of directors, the issue of shares or a significant shareholder buying or selling shares.

All the investment exchanges also have rules whereby persons who are likely to have unpublished price-sensitive information (e.g. directors and senior employees) cannot deal in that company's shares when they are in a “closed period”, i.e. whenever they are in possession of unpublished price-sensitive information or in the two months preceding the announcement of annual or interim results. Directors or senior employers may, in fact, not have information about the forthcoming results but they are, nevertheless, not permitted to deal in that company's shares as they are deemed to be in possession of unpublished price-sensitive information. The rules are designed to ensure that, as well as there being equality between market users, there seen to be equality between market users.

The second common thread is the rules on ongoing obligations that set out where shareholder approval is required. This, in turn, can be split into two categories, i.e.:

- (1) where shareholder approval is required because of the size of the transaction; and
- (2) where shareholder approval is required because of the identity of the person with whom the company is transacting.

The rules of all the investment exchanges have the concept of a “reverse takeover”, i.e. a transaction where the nature of the company before and after the transaction is

so different that the company can be considered to have a completely different character than before the transaction. In those cases, shareholder approval is required and the company is required to make a completely new application to be admitted to the investment exchange as it were a completely new applicant. This generally occurs where the quoted company undertakes a large acquisition, and so it is a misconception to believe that a reverse takeover is a cheaper and easier way of floating a company. Time periods and costs in a reverse takeover are generally longer than in an IPO because it involves an acquisition as well as a new application for admission. Nevertheless, there may still be good reasons for undertaking a reverse takeover, for example if the quoted company is a “cash shell” and/or if the quoted company has tax losses which can be utilised and/or the quoted company has a wide shareholder base.

The question of whether or not any transaction is a reverse takeover is determined by tests known as “class tests” which, for example, would measure the market capitalisation of the quoted company with the consideration it is paying or would measure the profits of the quoted company with the profits of the company to be acquired. If any of the tests give a result which is greater than 100% then the transaction will generally be considered to be a reverse takeover. In addition, the Listing Rules (which govern companies on the Official List) require shareholder approval for Class 1 transactions where the class tests give a result of 25% or more.

Shareholder approval is sometimes required if the party with whom the quoted company is transacting is a “related party”. A related party is, in essence, somebody who is a director of the quoted company or a shareholder holding more than 10% of the issued share capital of the quoted company or somebody who has been a director or a 10% class shareholder within the previous 12 months (although the rules on PLUS are slightly different). The Listing Rules require shareholder approval of a related party transaction (unless the class tests give a result of 0.25% or less in each case), but the AIM Rules do not require shareholder approval. Instead, they require the independent directors to announce that, having consulted the nominated advisor, they consider that the transaction is fair and reasonable as far as the shareholders of that company are concerned. The PLUS Rules just require an announcement of the related party transaction.

In any event, the Companies Act (or the equivalent legislation in the country of incorporation of the quoted company) will also provide similar requirements for shareholder approval in some cases and these must be dealt with in addition to the requirements of the rules of the relevant investment exchange.

<sup>1</sup> Financial Services and Markets Act (Financial Promotion) Order 2001

<sup>2</sup> The Prospectus Regulations 2005 (SE 2005/1433) which implemented the Prospectus Directive (2003/71/EC)



## CONTACT

Stringer Saul was founded in 1977. The firm currently has 26 fee earners. For the last 16 years Stringer Saul has primarily acted for high tech, "IP rich" clients particularly in the pharmaceutical and biotech sector and natural resources companies - from data mining to mineral extraction! However, we recognise that such clients need far more than just advice in their specialist areas and thus we have built up other key practice disciplines around the needs of our clients. Consequently, we offer a broad-based commercial law capability, together with highly specialist legal and commercial expertise in certain industry sectors.

### The culture of Stringer Saul

Stringer Saul LLP has a uniquely collaborative culture based on the following key points:

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From February 2007 Stringer Saul will change its name to Fasken Martineau Stringer Saul LLP, due to its merger with Fasken Martineau Dumoulin LLP, a top Canadian law firm with offices across Canada and in New York, London and Johannesburg.

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