STARTUPS IN THE UK
NAVIGATING THE NEXT PHASE OF GROWTH

In the second article of a two-part series, Jamie Moore, Kristy Hart, Kelly Hagedorn, Scott Morrison, Cameron Carr, Emma Cameron, Anna O'Kelly and Hanna Hewitt of Orrick explain the key issues and complexities that UK startups must navigate as they embark on their next phase of growth.

As a startup gains momentum, new hurdles and opportunities present themselves, demanding careful navigation and strategic decision-making. This article, the second in a two-part series, explores the essential aspects that UK founders must consider in the next phase of their company's evolution.

While the first part of the series looked at the key components of building strong foundations, part two focuses on the key issues that arise when growing a startup: from upholding directors' duties, securing financing, and fortifying the business against cybersecurity threats, to steering through financial challenges and seeking bridge financing (*see feature article "Startups in the UK: starting and scaling up", www.practicallaw.com/w-040-1311*).

COMPLYING WITH DIRECTORS' DUTIES

As a new business founder, becoming a director often comes with questions and concerns: what additional duties now apply, what processes and procedures can be put in place to ensure that a director is complying with their duties, and what directors' personal liability means? There are some key considerations for founders who are moving into their first role as a director and several ways in which they can mitigate the risk of breaching directors' duties.

Fiduciary duties and general statutory duties

Complying with directors' duties is crucial, as a breach of general duties may, in certain circumstances, be grounds for the termination of an executive director's service contract, lead to disqualification or cause company directors in breach to be characterised as acting in bad faith (*see box "A director's duties"*). The company could, for example, seek damages where a director has been negligent or rescind a contract in which the director had an undisclosed interest.

A director also has certain administrative duties, such as the duty to keep the company's statutory books up to date, file returns and to consider the interests of the company's creditors, especially where there is a possibility of insolvency (*see "Steering through financial difficulties" below*). These general duties are owed to the company and, therefore, only the company will be able to enforce them, except in limited circumstances where shareholders could bring a derivative claim for breach of duty on the company's behalf.

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A director's duties

The seven general directors' duties are set out in sections 171 to 177 of the Companies Act 2006.

Duty	Description
To act within powers	Directors should act in accordance with the company's constitution and only exercise powers for the purposes for which they were conferred. These include the appointment and removal of directors, the running of board and shareholder meetings, the handling of shares and how to manage directors' conflicts of interest.
To promote the success of the company	Directors should act in a way that they consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole. Factors to keep in mind include the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers and customers, and the need to act fairly as between members of the company. Where a factor is key to a particular decision, or where a decision is significant or controversial, the consideration of these factors should be clearly recorded in any board meeting or written resolutions of the directors.
To exercise independent judgment	This duty largely codifies the common law requirement for directors to exercise their powers independently, without subordinating their powers to the will of others and without fettering their discretion. Directors should not, therefore, simply follow other directors' decisions without assessing the facts and circumstances.
To exercise reasonable care, skill and diligence	Directors should exercise such reasonable skill, care and diligence as would be exercised by a reasonably diligent person with: • The general knowledge, skill and experience that could reasonably be expected from a person carrying out the director's functions. • The director's actual general knowledge, skill and experience. Directors should, therefore, read board papers and reports in advance of meetings and be prepared to discuss and question them.
To avoid conflicts of interest	Directors should avoid situations in which they have, or could have, a direct or indirect interest that conflicts, or could conflict, with the interests of the company. This could, for example, include avoiding holding multiple directorships or an advisory role with a competitor or on the board of a major shareholder, making personal use of the company's information or taking up an opportunity in order to make personal profit.
Not to accept benefits from third parties	Unless approved by the company's shareholders, a director should not accept a benefit from a third party that is given because of the position held by the director, or because of anything that the director has done in their capacity as a director, unless it can reasonably be regarded that it will not give rise to a conflict of interest.
To declare an interest in a proposed transaction or arrangement	Directors should disclose any direct or indirect interest that they have in a proposed or existing transaction or arrangement with the company. Any interests should be clearly recorded in any board meeting or written resolutions of the directors.

Personal liability

Under the Equality Act 2010, a director as an employee or agent of the business can be personally liable for unlawful discrimination committed by them in the course of their employment. A director may also be personally responsible (or jointly and severally liable with the company) for unlawful discrimination, harassment or victimisation, even where this takes place in the ordinary course of business or is authorised by the company.

Directors should make sure that appropriate policies are in place in the employee handbook to ensure that proper processes are followed in order to avoid any potential claims of discrimination. (*For more information on policies and procedures to implement in a startup, see the first article in this two-part series "Startups in the UK: starting and scaling up", www.practicallaw.com/w-040-1311.*)

An individual director, company secretary or manager of a company can also be held personally responsible for health and safety offences under UK law where:

- The company itself is found guilty of a health and safety offence.
- The offence was committed with the consent or connivance of, or was attributable to the neglect of, a director or manager.

It is therefore essential for a startup to implement robust health and safety protocols and ensure that these are followed in practice. A director who is convicted of a breach can also be disqualified from holding a director position for up to 15 years.

Protect against bribery and corruption

The Bribery Act 2010 contains four main offences:

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- Offering, promising or giving a bribe.
- Requesting, agreeing to receive or accepting a bribe.
- Bribing a foreign public official to obtain or retain business.
- Failure of commercial organisations to prevent bribery by their associated persons acting on their behalf.

Where a company, and not merely individuals acting on its behalf, is convicted of one of the first three offences above, its directors can be held liable jointly with the company (*see feature article "Bribery Act 2010: ten years on", www.practicallaw.com/w-026-9809*). The directors would have to have consented to the bribery in order to be prosecuted. A director found guilty of any of these offences could face a maximum penalty of ten years' imprisonment or an unlimited fine or both. A director convicted of bribery could also face disqualification from holding a directorship for up to 15 years.

While this offence relates to the company rather than directors individually, the board needs to be satisfied with the company's overall approach to preventing bribery. Directors should ensure that adequate procedures are in place to protect against bribery and corruption offences.

Allow for proper delegation

Directors can mitigate their liability through the implementation of proper and structured management systems, led by competent and dedicated personnel, with proper training and accountability to the board of directors. These systems should ensure, so far as possible, that the company is compliant with the obligations outlined in its constitutional documents. Directors must, however, continue to supervise and hold those carrying out the tasks to account. Regular meetings should be organised, ideally more frequently than board meetings, for updates and to monitor progress.

Put insurance in place

Putting in place insurance, such as directors' and officers' liability insurance, for the company's directors and the directors of an associated company against liability in connection with any negligence, default, breach of duty or breach of trust by them in their roles as directors could be crucial.

If the company already has insurance in place, a new director should ensure that the insurer is aware of their appointment and confirm that they will be covered by the policy.

Directors' indemnities

The company may indemnify a director against the costs of a claim against them. This includes defence costs and any costs incurred in an application for relief to the court, provided that the director repays the costs if they are unsuccessful. A company will not, however, be able to indemnify a director from any liability for negligence, default, breach of duty or breach of trust in relation to the company.

The articles of association of a company usually permit the company to indemnify directors. However, the indemnity itself must be contained in the director's service contract or a standalone deed of indemnity. Any indemnities given to directors have to be disclosed each year in the directors' report that accompanies the company's audited accounts, and their terms have to be available for inspection by shareholders at all times.

Ratification of previous decisions

All is not lost if directors make mistakes: certain matters of conduct by a director that amount to negligence, default, breach of duty or breach of trust in relation to the company can be ratified, by a process regulated by the Companies Act 2006. Any decision must be taken by members without reliance on the votes of the director or any connected person.

Judicial relief

Where other avenues have been exhausted in the context of proceedings brought against a director for negligence, default, breach of duty or breach of trust, the court may relieve the director from liability if it considers both that:

- They have acted honestly and reasonably.
- Considering all the circumstances of the case, they ought fairly to be excused.

A director may also apply to the court for relief where they have reason to expect that a claim may be made against them.

GET READY TO RAISE

For almost all businesses, once they are up and running, seeking to expand requires additional investment. For many founders, raising funding in order to allow that growth to continue can be a particularly stressful time. Sourcing and managing potential investors while continuing to run the business all become part of the day-to-day process. There are several key considerations that UK startups need to think about when structuring an equity fundraising, bringing new investors into the ownership of the company and negotiating what rights they will have.

Understanding the cap table

A capital table, or "cap table" provides investors with a comprehensive overview of the company's share capital and the dilutive impact that a round of fundraising, including any option pool top-up, convertibles and rolling closes, will have (*see "Raising bridge financing" below*). Both founders and investors need to understand the percentage ownership of the company as this will affect board appointment rights, consent thresholds, de facto veto rights, and information rights (*see "Information rights" and "Consent regimes" below*). Understanding who is a controller of the company is also important if it is a regulated business.

It is also important that owners and investors both know what entities sit on the cap table; this is a surprising point, but startups can often get this wrong, especially where an investment is made through a syndicate or fund where the underlying investors hold the shares in their personal capacity. Mismanagement of the cap table can also trickle through to incorrectly composed company registers and could cause delays to completion of the financing round.

Due diligence and the data room

Most venture capital (VC) investors will insist on some form of legal due diligence. A template due diligence questionnaire can provide the building blocks to start populating the data room early; the sooner this is done, the better (*see box "Information required by investors"*).

Warranties and disclosure

Almost all investors will insist that the company give warranties as part of the investment round. Sometimes this extends to the founders personally, although new market data suggests that it is quite common to have no founder-given warranties (*see www.orrick.com\en\Insights\2023\03\Deal-Flow-3-5-Things-We-Learned-About-European-Tech-Deal-Terms-in-2022 for more market insights*). These warranties are contractual promises

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from the company to the investors as to the health of the business and allow the investors to make an informed assessment of their investment. If the company cannot give a warranty, it will need to disclose this to the investors in a disclosure letter.

The warranties are usually a key point of negotiation and there are some key elements to consider.

Scope. If there are converting investors as part of the financing round (that is, investors who invested through a convertible instrument like a convertible loan note, advance subscription agreement or simple agreements for future equity, the conversion of which is triggered by the financing round), it is worth considering whether the warranties should be extended to these converting investors or whether the warranties are given to the new money investors only. It is also important for the company to consider whether the warranty suite is appropriate for the stage and size of its business.

Limitations. The maximum liability of the company for a breach of warranty claim should not be more than the aggregate amount that is invested in the round, which will exclude any convertible funds to the extent that the converting investors are not being given the warranties. In addition, it is worth looking at limiting the time period which the company is vulnerable to a breach of warranty claim. For seed rounds, it is common for these to settle anywhere between nine and 18 months.

Founder vesting

One of the more heavily negotiated terms of a round of equity investment is founder vesting. The intention is to reduce the potential impact of a founder leaving the company by putting some or all of their equity in the company "at risk"; that is, by making it subject to repurchase by the company or conversion into economically worthless deferred shares, during the vesting period.

Vesting and leaver provisions. A typical vesting schedule is four years monthly, with a one-year cliff, which means that a lump 25% of the founder shares vest after one year, with the remaining 75% vesting monthly over the following three years. Where a founder leaves as a good leaver, which is usually with mutual agreement and in non-contentious circumstances, that founder can keep the shares that have vested. If a founder leaves as a bad leaver, usually in contentious circumstances, they would normally lose all of their founder shares.

Information required by investors

Investors are likely to require information relating to:

- The company and the shareholders.
- Financial information such as the annual and management accounts and any loans and debt facilities.
- Documents relating to registered and unregistered company intellectual property and the company's IT stack.
- Customer and supplier agreements.
- All template employee and contractor documents, including anonymised data relating to the company's workforce and any employee benefits, such as share options.

Upfront vesting and vesting commencement date. It is not unusual for vesting to be reset on a subsequent funding round. To acknowledge a founder's contribution to the business up to the investment date and in recognition of any previous vesting schedules that the founders have been subject to, founders can request for a portion of their founder shares to be excluded from the vesting provisions. Those shares are deemed to be "earned".

Information rights

Investors will often request the right to receive certain financial information about the company, such as annual accounts, management accounts and the annual budget and business plan, in order to allow them to monitor the progress of the company and their investment, as well as meet their own internal fund reporting requirements.

In negotiating these rights, it is worth considering whether it is appropriate to limit which investors receive the company's financial information and whether the volume of information requested is proportionate to the stage and size of the business. It is, however, worth noting that a light-touch information rights regime is not a reason for poor corporate governance and companies should seek to build good corporate governance systems early on.

Assembling the board

Investors will often request a right to appoint a director to the board. This enables investors to ensure that they have additional avenues to provide for ongoing access to information regarding their portfolio companies. It is important to consider tying this right to an equity floor; that is, the investor must hold a minimum of, for example, 5% of the equity shares to ensure that as the company grows, the board does not become overcrowded with investor directors who hold immaterial shareholdings.

Consent regimes

As the founders are usually the majority shareholders and directors of a company, especially at the early stage, VC investors will negotiate for negative controls over the company in order to ensure that certain actions cannot be taken by the founders without their consent. These are usually in the form of:

- Investor majority consent matters. These go to the heart of the economic value of the shares held by the investors, such as matters affecting the company's share capital and rights, or the adoption of new articles of association.
- Investor director consent matters These include administrative and operational matters relating to the business of the company, such as expanding to a new jurisdiction, approving the company's budget, or incurring material expenditures.

When negotiating who constitutes the investor majority, it is important to set the investor majority consent threshold at the correct percentage in order to avoid an investor deadlock. It is also important to

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ensure that no single investor is given a veto over decisions that would hinder the company from being able to operate efficiently in the future. Likewise, founders should ensure that the requirements for investor director approvals will not hinder the company from operating its day-to-day business.

An additional protection for the founders is to require founder approval in addition to any investor majority consents to ensure that the founders have an equal say. Founders should think about this from an early stage so that it can carry through in future investment rounds where they might have a lesser say by virtue of their shareholding alone.

Other legal provisions

Other legal provisions are often included in term sheets for equity investment including drag, liquidation preference and anti-dilution.

Drag along. These provisions allow a majority of the shareholders that wish to sell their shares, to "drag", or force, the minority shareholders to also sell their shares. It is also common to see a founder veto over the exercise of the drag provision in earlier stages of financing, which will then drop off in the later stages.

Liquidation preference. A typical liquidation preference is a one times non-participating preference, which gives the investors their money back first, ahead of nonpreference shareholders, in a liquidity event. This has been the market standard for a number of years, however, in an uncertain market, investors might push for a higher multiple or a participating preference. 2023 has seen an increase in these terms.

Anti-dilution. This protects the investors from their investment being diluted if the company raises further investment at a lower valuation. Broad-based weighted average anti-dilution protection continues to be included in investment documents in earlier financing rounds and remains for longer into later financing rounds.

The fundraising process

From the time of signing a term sheet, negotiating and completing an early-stage equity funding round can, for simple deals, take an average of six to eight weeks, and sometimes longer for more complicated deals or if there are any unanticipated issues in the funding round process. If there is a more immediate need for funds, then to bridge this interim period, it is possible for either existing or incoming investors to invest some capital in advance through an instrument such as an advance subscription agreement or convertible loan note, which will convert when the equity round completes (*see "Raising bridge financing" below*).

SEIS and EIS. It is best to know as early as possible whether there will be any Seed Enterprise Investment Scheme (SEIS) or Enterprise Investment Scheme (EIS) investors, as a number of structural changes will need to be incorporated in the investment documents in order to accommodate them. For example, in order to ensure that the business does not exceed the £200,000 (or £250,000 from April 2023) gross assets threshold, the SEIS investment monies will need to be received first, with the SEIS shares issued immediately in exchange for the fresh injection of cash. SEIS or EIS requirements will also dictate the rights, and potentially the class, of shares that need to be issued.

Option pool dilution. An option pool is normally expressed as a percentage of fully diluted share capital, meaning that it includes shares and share options that have not yet been granted as well as any shares and options that are already allocated to the founders. If the unallocated option pool is going to increase as part of the funding round, founders will need to consider whether this increase will be counted in the pre-fundraise valuation or the post-fundraise valuation. If the increase is counted in the pre-fundraise value, then dilution will affect the founders and existing shareholders; on the other hand, if it is in the post-fundraise value then the new investors will also be diluted.

Rolling closes. After the investment documents have been negotiated with the investors, it may be the case that the fundraising round is not fully subscribed for, or that some of the investors are going to need more time to complete. In such cases, it is worth considering structuring the fundraising to accommodate rolling closes, that is, a further closing or multiple closes that will occur within a period of 30 to 90 days from the initial close to bring in any additional or late investors. However, all board, shareholder and investor consents should be obtained at the initial close to avoid the additional administrative burden.

Currency. In today's global market, investors might value the company and their investment in a different currency, such as US dollars. UK companies should be aware that raising in a different currency might present a foreign exchange risk from fluctuating exchange rates and may present additional complexities if the existing liquidation stack of the company has previously been priced in pounds sterling. However, if some investors are themselves from the US, then in some cases more substantial changes to the startup business may be required in order to give the US investors the comfort that they require by investing on familiar terms (*see box "US expansion"*).

THE CYBER THREAT LANDSCAPE

For many, cybersecurity is an area that is intimidating and hard to navigate, especially for smaller companies that often lack the resources, and sometimes knowledge, to protect effectively against cyber risks.

Individuals or groups that target companies with cyber threats, known as "threat actors", continue to aim primarily at companies that are highly likely to pay a ransom, or those lacking cybersecurity defences, including companies that are: intellectual property (IP) or data-rich, important to supply chains, in industries such as financial services, healthcare and energy, or perceived to work with governmental bodies, and small or earlier stage businesses with limited cybersecurity defences.

Who and what to protect

Using the business plan as a starting point, founders should start by assessing the value of the business's current and future data assets to ensure that time and resources are effectively directed to high-risk areas. For many early-stage companies, IP and confidential information can be the most valuable assets. Prioritising the protection of customer personal data is also essential. A comprehensive map of the data that the business holds can assist with decisions on how time, resource and budget is allocated.

What and how the data is protected should also be adapted to reflect the risks of the relevant industry, including any industry-specific laws, such as the Network and Information Systems Regulations 2018 (*SI 2018/506*) and the Network and Information Security Directive (*2016/1148/EU*) in the UK and the EU, respectively, and the Electronic Communications (Security Measures) Regulations 2022 (*SI 2022/933*) in the

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UK (*see Briefing "Extended cyber security requirements: the picture in the EU and the UK", www.practicallaw.com/w-039-2445*).

Ensuring systems are protected

Most early-stage companies rely on third-party technology, such as cloud-based systems and a remote workforce, which can pose cybersecurity challenges.

To protect a company's systems, a new business's security team should continually work to identify areas of weakness and deploy proportionate solutions, such as implementing secondary authentication mechanisms (for example, multi-factor authentication), regularly rotating user passwords and auditing privileged accounts on a regular basis. Third-party vendors can also be used to monitor threats both internally and externally.

As the company grows, personnel will change. Therefore, it is vital that time is spent documenting the cybersecurity processes to ensure continuity and demonstrate regulatory compliance. There should be a clear audit trail of security changes, whether for internal or external purposes.

Incident response plan

Founders need to ensure that the security culture of the business is incident ready. During an incident, a disconnect between security teams and the wider company can hinder co-operation and reduce a company's ability to work efficiently towards containing the incident.

A startup should map all areas of its business to create an incident response plan that sets out the processes for managing a cybersecurity incident, and outlines the external vendors that can provide support in an incident and the structure of teams that will collaborate during an incident. Preparation is essential in order to focus key stakeholders during a cybersecurity threat. This plan should be reviewed and updated on an ongoing basis to ensure that it grows with both the company and the evolving threat landscape.

Vendor security

When negotiating with vendors, a startup's contracts should include cybersecurity provisions detailing what the business expects the vendor to do to mitigate cybersecurity risks. These may include notification and escalation obligations, warranties that the vendor will comply with their cybersecurity obligations and indemnities to make the vendor liable for any costs arising from a failure to do so.

In response to increased regulatory attention to supply chain cybersecurity attacks, particularly following high-profile incidents such as the 2020 SolarWinds attack, the UK National Cybersecurity Centre released new guidance in October 2022, aimed at helping companies to assess cybersecurity in their supply chains (*www.ncsc.gov.uk/collection/assess-supply-chain-cyber-security*).

Costs and budgets

According to a survey by the Department for Digital, Culture, Media and Sport, UK SMEs have taken few proactive steps on cybersecurity, in part because of competing budget priorities (*www.gov.uk/government/statistics/cyber-security-breaches-survey-2022/cyber-security-breaches-survey-2022*). To help overcome this, security teams need to drive cyber awareness at board level at an early stage to enhance buy-in.

Investing in large-scale capital projects, including those that ensure safety against potential cyber threats, is essential for long-term economic growth and ensuring a company's ongoing resilience.

Many early-stage companies do not invest in cyber insurance, despite the increasing frequency of cyber attacks (*see feature article "Changing face of cyber insurance: the devil finds work for idle hands", www.practicallaw.com/w-031-9892*). The cost of cyber insurance

US expansion

Many UK founders consider moving their company to the US at some point in their lifecycle. Whether companies are looking to access funds from US venture capitalists (VCs) or to capitalise on the US product market, many startups ultimately incorporate a Delaware holding company, or US TopCo, in a transaction that is often referred to as a "Delaware flip".

There are three primary reasons why a UK company might decide to flip to a US TopCo. Firstly, flipping gives UK companies easier access to US capital. While an increasing number of US VCs are happy investing in UK companies, most US investors still feel most comfortable with the corporate mechanics and standardised forms of investment documents of a US corporation, and so in some cases may require it before closing their investment.

Secondly, flipping to the US may provide access to more US exit opportunities, including initial public offerings on US markets. Finally, UK companies may expect their employees, product market and operations to be based primarily in the US in the future, so that incorporating a US parent is desirable.

When restructuring any company, tax considerations are often paramount. UK companies engaging in a Delaware flip should ensure that they consult counsel on the tax implications of the transaction for their shareholders and any tax relief schemes that they participate in, as well as for the UK and US companies themselves.

UK companies engaging in a Delaware flip will often be expected to adopt a certificate of incorporation and shareholders' agreement based on the National Venture Capital Association (NVCA) forms.

An important part of a flip transaction is making sure that all rights to securities are moved to the new US TopCo. Companies will want to ensure that the tax treatment of any existing equity incentives is rolled over to the new Delaware holding company.

US market practice for founder vesting differs from many European jurisdictions. Founders are often only subject to time-based vesting and are not subject to a clawback of vested shares in the event that they are deemed to be bad leavers. It is also market practice for founders' shares to be subject to double-trigger accelerated vesting in the event of termination in connection with a change of control of the company.

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can be a deterrent, however, the potential losses arising from a cyber incident can be significant. Insurers are interested in clients that exhibit cybersecurity maturity, which is more important to them than the size of the organisation. A diligent approach to cybersecurity can reduce an insurance premium dramatically, therefore saving on costs.

Regulatory compliance

Regulatory fines or sanctions can be the greatest financial and reputational exposure arising from a cybersecurity incident.

Along with the steps above, which can all help to demonstrate compliance to regulators, founders should examine the activities of their business and consider whether they involve regulatory risks. Regulators are particularly concerned about incidents involving large quantities of personal data or sensitive personal data, such as health data. In some cases, an incident can expose a business to risks from several regulatory regimes across multiple jurisdictions. For example, if a health technology company controls or processes health information, it will need to consider whether it has obligations under the the EU General Data Protection Regulation (*2016/679/EU*) (GDPR) and the retained EU law version of the GDPR (UK GDPR), as well as the Health Insurance Portability and Accountability Act of 1996 in the US.

Cyber maturity

Cyber maturity is important as a company grows and faces more complex issues. At any stage, regular discussions about cybersecurity issues should be had throughout the company. An early-stage company might hold these conversations at bi-annual or quarterly board meetings, whereas a larger company may establish smaller committees focused specifically on cybersecurity.

A key indicator of cyber maturity and company maturity growing alongside each other is the ease and speed at which cybersecurity discussions shift in relation to developing demands, such as in the event of a merger or acquisition, or if the business is looking to introduce a new product or service.

STEERING THROUGH FINANCIAL DIFFICULTIES

Coming from a vibrant and founder-friendly year in 2021, global economic headwinds took a toll on high-growth technology-focused businesses in the second half of 2022 and have continued to do so in 2023. Markets have witnessed a correction in valuations, which has resulted in a slow-down in equity investments, a retraction of the volume and size of investments, and less favourable terms for founders looking to raise finance in 2023. The reduction of available capital may have left less fortunate companies facing financial distress.

When a company falls into financial difficulty, the cost base of the company and the business plan should be reassessed to consider whether any non-essential costs can be cut out of the business. This may involve processes with respect to redundancies, or terminating or renegotiating legal agreements such as consultation contracts, leases and existing contract terms (*see feature article "Redundancy: the new normal?", www.practicallaw.com/w-027-8151*). Careful attention to proper processes should be made in these scenarios. However, in some cases, these measures will not be sufficient and founders need to be prepared to look at other options.

Alternative sources of funding

While markets recover, founders may look to other sources of funding rather than facing a so-called "down round" of finance, the terms of which may be too dilutive or particularly punitive in the current investor-friendly market. Founders could rely on their existing investors to provide bridge funding through convertible debt or consider secured debt from third-party debt providers to acquire capital to bridge the gap to their next equity round or exit (*see "Raising bridge financing" below*).

While these sources of funding may be considered expensive, as they often include high interest rates and an equity kicker, debt funding may provide the company with a welcome lifeline until the next equity round. Any lender seeking to provide debt funding will likely wish to protect against a downside scenario and ensure that the company has assets or is capable of generating positive cashflow to service the debt in the event that the next equity round is delayed or not forthcoming.

The tax implications of any such alternative funding should also be considered, including whether that funding could give rise to a withholding tax liability if an exemption is not applicable.

Contingency plans and directors' duties

When a UK company is in sufficient financial distress that the company is insolvent or an insolvency is probable, the general duty of directors to act in a manner that they reasonably believe will promote the success of the company for the benefit of the shareholders, is supplemented by a duty to act in the best interests of the creditors of the company as a whole (*BTI 2014 LLC v Sequana SA and others [2022] UKSC 25; see News brief " Directors' duties: considering creditors' interests in the zone of insolvency", www.practicallaw.com/w-037-3493*).

When the duty to creditors arises, the directors should balance the interests of shareholders and creditors to the extent that they conflict. The greater the company's financial distress, the more directors should prioritise the interests of creditors. Therefore, while the primary focus of the directors of a company that is insolvent, or on the brink of insolvency, may be to secure additional funding in order to enable the business to continue to operate, they should also explore other alternatives. This may include pursuing an exit or a sale of the business or assets of the company.

In the event that the preferred solution becomes unattainable, directors should ensure that there are alternatives in place that maximise the value of the business and, ultimately, minimise losses to creditors. When evaluating the merits of those alternative transactions, the tax treatment for both the company and, where relevant, its stakeholders should also be considered. Running alternative processes in parallel may also be prudent to ensure that a transaction may be implemented swiftly for the benefit of the creditors.

To the extent that an insolvent liquidation or administration becomes inevitable, the interests of the creditors become paramount, as the shareholders no longer have a valuable interest in the company. Directors should seek specialist legal and financial advice from an insolvency practitioner as soon as possible. They can advise the directors with respect to their duties and ensure that they do not take action that could result in personal liability, should the company enter into an insolvency process.

Meet regularly and keep records

The financial position of the company can change rapidly. Boards should therefore

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meet as frequently as is reasonable in the circumstances, even daily if the financial distress is particularly acute, to consider whether the company is insolvent and to assess whether there remains a reasonable prospect of avoiding an insolvent liquidation or administration.

If a company does enter into an insolvency process, the appointed liquidator or administrator will scrutinise the conduct of the directors before the insolvency to consider whether there are any potential actions that could be brought to maximise the assets of the company and also for the purposes of preparing a report to the Secretary of State with respect to their conduct.

In the event that the conduct of a director is considered to be sufficiently poor, they may be disqualified from acting as a director on an application under the Company Directors Disqualification Act 1986. Keeping minutes of board meetings that record the decisions made by the directors will provide evidence to an insolvency practitioner that the directors have acted appropriately, sought specialist advice considering their duties and acted in a manner that they reasonably believed to be in the best interests of the creditors of the company.

Consider group companies separately

Where the group is financially distressed, directors of each company should consider whether any particular course of action is in the best interests of each group company, and their respective creditors, separately. There may be circumstances where the interests of all companies within a group, and their respective creditors, are aligned (*see feature article "Intra-group reorganisations: directors' duties in times of stress", www.practicallaw.com/w-028-3705*).

However, there may be certain circumstances that give rise to potential conflicts; for example, where groups have operated centralised cash-pooling arrangements and certain companies are reliant on the provision of cash from other group companies and directors need to consider whether those arrangements should be terminated. Any potential conflicts should also be managed by ensuring that there is some independence on the boards of each different group company.

Avoid wrongful trading

In the event of a liquidation or administration of a UK company, directors could potentially face personal liability for wrongful trading. Under section 214 of the Insolvency Act 1986 (1986 Act), an appointed administrator or liquidator may seek an order of the court that the directors of the company contribute to the assets of the company if:

- The director concluded or ought to have concluded that there was no reasonable prospect of the company avoiding an insolvency liquidation or administration.

- There is an increased deficit to the loss suffered by the creditors of the company.

The court will not make an order for contribution in circumstances where the directors took every step with a view to minimising losses to creditors. Therefore, directors should assess whether the company has a reasonable prospect of avoiding an insolvent liquidation or administration on an ongoing basis and ensure they act with a view to minimising losses to creditors (*see feature article "Navigating turbulence: opportunities amid a deluge of disruption", www.practicallaw.com/w-026-9048*).

Avoid preferential transactions

A preferential transaction is a transaction where a company pays one creditor in preference to other creditors and may arise where:

- There is a debt due from the company to a creditor.

- The company does something, or suffers something to be done, that has the effect of putting that creditor in a better position than it would have been in had the action not occurred.

- There is a desire from the company to put that creditor in a better position. This is a high threshold for a liquidator to prove and one that academic commentary suggests will not be found unless the company positively wished to improve the creditor's position in the event of its own insolvency.

- The action took place within the relevant time; that is, two years before the onset of insolvency if the creditor is connected to the company and six months before if the creditor is a non-connected recipient.

- The company was unable to pay its debts at the time of the action or as a result of it.

If the creditor is an associate of the company, a rebuttable presumption will arise that the company intended to put that creditor into a better position.

A liquidator may apply to court for an order to restore the position to what it would have been had the company not given the preference. Under section 239(3) of the 1986 Act, the court shall make such order as it sees fit. This power of the court is very wide and can include an order forcing the person who entered into the transaction, or who received the preference, to return the property or its value to the company.

Therefore, directors should be cautious about paying certain creditors over others, unless there is a genuine commercial reason for doing so.

Avoid transactions at an undervalue

Divesting of assets belonging to the company may be a way of obtaining additional cash to allow a company to continue to trade and bridge the gap to a future capital injection or exit. However, directors should take caution to avoid a transaction at an undervalue. In an asset sale in a distressed scenario, the company may not receive full value given the need to sell urgently.

A liquidator or administrator may apply to the court for an order to set aside gifts or transactions made by the company before it became insolvent where the company received inadequate or no consideration. In the case of a transaction with a person who is connected to the company, such as a director or associate of a director, that transaction will be vulnerable if it was entered into during the period of two years before the company went into liquidation.

In order to be liable to be set aside, the company must have been unable to pay its debts at the time of the transaction or became unable to pay its debts as a result of the transaction. However, if the transaction is with a connected person, the court will automatically presume this to be the case unless proven otherwise. That is, it will be incumbent on the party opposing the order, such as the connected party or a director required to make a contribution, to prove that the company was not made insolvent in connection with the transaction.

A court will not make such an order if it is satisfied that the company entered into the

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transaction in good faith and for the purpose of carrying on its business, and that, at the time it did so, there were reasonable grounds for believing that the transaction would benefit the company.

A transaction at an undervalue, which is not on arm's length terms, may also be challenged from a tax perspective, under transfer pricing or anti-avoidance principles.

Instruct professional advisers

Seeking advice from legal and financial experts can assist in providing a defence to any potential claims by an insolvency practitioner if the company later enters an insolvency process. Advisers can also assist in identifying areas of risk where directors could potentially be in breach of their duties and provide guidance in dealing with circumstances that many directors may not have experienced.

Taking tax advice in advance of implementing any proposed financing or financial restructuring, with a view to identifying potential tax exposures, and, where possible, seeking to structure the transaction in a tax efficient manner, is also important. Potential tax exposures that could be relevant include withholding tax, the triggering of taxable loan relationship credits in the debtor entity where debt is released or amended, and stamp duty charges on certain transfers of debt or equity.

RAISING BRIDGE FINANCING

Convertible securities such as simple agreements for future equity (SAFEs), advance subscription agreements (ASAs) and conventional convertible loan notes (CLNs) are increasingly used as agile and flexible funding instruments, as they can provide companies with short-term, quick-access capital that only converts into equity based on future events or valuations.

When conversion happens

The right to convert convertible securities is usually triggered on certain future events, such as a future financing round where at least a certain threshold of further funding is provided, an exit event, an initial public offering, or on a set longstop or maturity date.

Conversion can either be automatic, that is, immediately before one of the trigger events, or at the choice of the investor, that is, where a financing has taken place, but where it does not meet the threshold specified for it to be an automatic conversion.

Automatic conversion can provide the company, existing investors and incoming investors with certainty that the company will be going into its next financing round or exit free of debt and removes any unnecessary friction from the conversion process.

What the instrument converts into

The trigger event would normally influence the class of share that the investment amount converts into.

As part of the incentivisation rubric of convertible instruments, it is usual for the investment amount to convert into the most senior class of shares issued on the company's next financing round, usually at a discount as a sweetener. It is worth noting that if there are EIS investors and they are using an ASA (as EIS is not compatible with convertible debt), additional drafting will be needed to ensure that the longstop date is no more than six months from the date of investment and that the investment amount converts into an ordinary class without certain preferences. This ensures that the conversion shares can be EIS-eligible.

On the longstop date, an exit event, an initial public offering or an insolvency, the investment amount would normally convert into either the most senior class of share currently in issue, or into ordinary shares.

Conversion price

There are a number of mechanisms that play into the price per share on a conversion event and which can be used to incentivise investors to provide the bridge financing required to get a startup company to its next equity funding round.

Discount. As early-stage convertible investors will be investing in the company at a pivotal and riskier stage in its lifecycle without immediately receiving any of the benefits and investor protections that are enjoyed by investors on an equity financing round, one way to incentivise investors to invest is to offer them the ability to convert at a discount on the conversion price associated with certain trigger events.

Valuation cap. The valuation cap is designed to provide a ceiling on the conversion price. Where the next round valuation is higher than the valuation cap, the investment amount will convert at the cap, resulting in the investor

Common terms in convertible instruments

Some of the more common terms that are requested by lenders under convertible instruments include:

- Information rights to allow investors to monitor their investment and comply with their own reporting duties to their limited partners.
- Consent rights for investors on key decisions relating to the company. Convertible debt investors have traditionally not obtained consent rights on their convertible investment as they are not equity shareholders at the time of the investment.
- Pro rata entitlement to participate on the company's next equity financing.
- Director or observer appointment rights on the next equity financing. The recent increase in these rights is a sign that being able to accurately track and influence portfolio company performance is at the forefront of investors' minds during choppier economic times.
- Most-favoured nation provisions, which, in essence, allow investors to cherry pick superior terms from subsequent convertible instruments and absorb those terms within their own convertible instrument. To the extent that a business does not intend to issue any more convertibles (on different terms, for example, with a bigger discount) ahead of the next equity round on which the convertibles will convert, this should not be a controversial request to accept. However, where it is likely that additional convertible investors will come in on more advantageous terms, it is worth pushing back on this request.

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receiving an increased number of shares to that which they would have otherwise received. This provides the investor with a significant benefit for taking the additional risk and investing early.

Interest payable on the instrument

As a debt instrument, CLNs will usually accrue interest from the date that the funds are advanced until conversion or repayment. The applicable interest rate is a commercially negotiated term and will often be dictated by the circumstances of the bridge financing and the perceived level of risk being taken by the investors.

Unlike CLNs, SAFEs and ASAs are equity instruments and so do not typically accrue interest. Furthermore, accruing interest would prohibit an ASA or SAFE from being EIS or SEIS eligible.

Notably, in the case of a CLN, accrued interest is rarely paid in cash while the instrument is outstanding, and more often gets rolled up and added to the principal amount to be repaid or converted on the applicable trigger event as if it was part of the original capital.

Redemption

Unlike ASAs and most SAFEs, which do not usually provide for redemption of the investment amounts, CLNs will often include a redemption provision. This allows the investor to demand repayment under certain circumstances, such as on an event of default, such as an order being made for the winding-up, liquidation, administration or dissolution of the company, or allows the company, sometimes with the prior approval of the investor or a majority of the investors, to seek to repay the debt before conversion on a trigger event.

Redemption can sometimes carry a premium to balance a high-risk profile of an investment. In such circumstances, the company is required to pay back the principal amount of the debt along with a redemption premium, most commonly 200% of the principal amount, as well as any accrued interest.

From the company’s perspective, although not unusual, this can result in the debt being expensive and should be resisted. Redemption premiums can form an important part of negotiations in distressed financing scenarios where there is a risk that the company may not be able to deliver on its business plan, is underperforming, or is in danger of triggering an insolvency event.

Security

Taking security is not market standard and is generally not viewed as appropriate in the context of convertible financing rounds of early-stage startups. The limited occasions where investors may request security over the company’s assets are in distressed financing scenarios where investors invest money as a way to rescue the company from potential insolvency and therefore require the additional comfort given by obtaining security against the company’s assets (*see “Steering through financial difficulties” above*).

Tax considerations

One of the benefits of ASAs is that, if drafted appropriately, individual investors who are subject to tax in the UK may be able to benefit from certain tax reliefs in respect of the shares issued under ASAs, specifically the EIS and SEIS.

One of the key requirements of these schemes is that EIS or SEIS investors invest their money in exchange for equity in higher risk, early-stage companies, therefore the investment cannot resemble debt or carry investor protections that could otherwise protect that investor’s return.

Unlike CLNs, the features of which reflect a debt-like position, such as the ability or obligation to repay in certain circumstances, the duration of the loan, and the inclusion of interest, ASAs convert into equity in all

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circumstances and do not include these debt-like terms. As a result, ASAs are more likely to be eligible for EIS or SEIS relief.

This is a highly technical area requiring specific tax advice, so founders should always seek specialist advice to ensure that the proposed investment would qualify for EIS or SEIS, and investors should seek their own tax advice regarding their personal tax position and eligibility for EIS or SEIS.

Warranties

More common in the context of a CLN rather than an ASA or SAFE, investors will sometimes seek additional protection through the inclusion of warranties provided by the company. Warranties are statements of fact given at the time of the agreement about issues such as the state of the company's business, its assets and any potential liabilities, that give investors additional comfort around the value of the investment they are making.

In a convertible financing, a full suite of warranties such as those that are common in an equity investment round, is unlikely, but certain title and capacity warranties, as well as very limited business warranties can sometimes be included.

To the extent that the CLN includes warranties, a business should consider whether the CLN investors should then also benefit from the warranties given at the time of an equity financing.

Other terms

Convertible instruments are intended to be a quick and easy way to raise capital. In contrast to traditional equity rounds, convertible fundraising involves short-form documents and fewer terms to negotiate, as the investor is not actually receiving equity, to which many of these rights attach, at the time of the investment.

Some investors, however, want to secure their position in respect of certain key investor rights on conversion of their convertible instruments, and sometimes more investor-friendly positions will be negotiated in convertible financings, mostly in the form of side letters (*see box "Common terms in convertible instruments"*).

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New in-house content on the Consultation board round table: hot topics for 2023

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