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Spin-out Companies

A Researcher's Guide

Contents

Introduction

You are about to embark upon a very challenging enterprise. Whatever its nature and scale, the setting up and running of any spin-out company from a research institution involves similar principles and steps. This Guide is intended to help you by providing an overview of the whole process. In particular it aims to:

- Inform you about the process and various types of documents, terminology, issues, people and organisations that you will encounter;
- Alert you to the role and responsibilities of a director of a company; and
- Set your expectations regarding the level and nature of your involvement and influence.

Your university, NHS trust or other research-based institution and/or its IP commercialisation organisation will be able to advise you and work with you on spin-outs. Business people and specialists will be working with you too. This Guide will aid you in these relationships. You will be able to use it regularly as a handy reference.

Remember that this is just a guide and not a substitute for you taking your own independent professional advice from time to time.

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Why create a spin-out company?

Spin-outs originating from research institutions are usually set up when there is no existing business to approach about a significant breakthrough in a field of work or because the work has clear possibilities to generate many products and applications and so potentially could be extremely valuable. These are called “platform opportunities” or “disruptive technologies”.

Creating a spin-out company is a fundamental decision. It will have ramifications for you as a researcher which you have probably not yet considered.

There are various ways of commercialising the intellectual property (“IP”) which you have created. These include selling the IP outright and licensing it. There are various reasons however why you may want to consider a spin-out company. Some benefit is sometimes perceived through distancing the IP from the research environment of your institution. This however should not be the key driver.

To be effective a spin-out company will need to bring together various assets and resources to commercialise the IP. These resources are likely to include money, but almost certainly will include other things such as specialist management and facilities such as laboratories and/or manufacturing. Some IP based spin-out business models will seek to outsource manufacture and distribution and to license some or all of its IP.

Remember once the IP is transferred to the spin-out company it is no longer available for you to use. The company may grant a research licence back but this will not allow use of it to help commercialise any future IP.

This is to keep costs low and also to enable the spin-out to focus on the issues and activities which its originators and newly-appointed dedicated managers will be good at, such as IP development, marketing and customer training. So do not feel that you have to get involved in building extensive infrastructure facilities or international supply chains. There are possibilities for renting suitable laboratories and for placing contracts with a research institution too.

Why create a spin-out company?

Successful spin-out companies need four very necessary ingredients:

- **IP** – The innovation which you have created and which is protected by IP will be indispensable to the spin-out company. In 2005 the British Venture Capital Association in its report on university spin-out activity in the UK rated IP protection as particularly important for a spin-out company (see Section 2 – Intellectual Property).

  You do need to consider how IP and the ideas which it protects will be applied in the market. They need to be able to form the basis of a sustainable business opportunity which can generate a return for investors. Do your market research early. The "proof-of-market" is as important as the "proof-of-principle".

- **Management** – Investors in the company will expect the company to be led by a team with proven management skills. This will involve the need to attract a range of individuals with a balance of top-class skills in fields such as management, finance, marketing and sales. Probably many will have had previous successful experiences of start-ups. It may also require you to take more of a back seat in terms of the company's management. Success will be dependent on new people becoming involved at various stages in the growth of the company. It cannot remain under the control of one person forever.

- **Money** – the company will need money to develop and grow. There are various possible sources of funding available (see section 5). These may range from your institution's own resources to business angels or venture capitalists. Some researchers even raise money from family and friends. Whomever you turn to you will need some sort of plan to put before them. You will therefore need to create a Business Plan.

- **You** – as the IP originator, you are essential to the transfer of IP to the company. Your continuing involvement with the IP's development and your ongoing commitment to the enterprise and support to the company's business managers is vital.

BUSINESS PLAN CONTENT

Executive Summary – a clear persuasive summary of the plan which tempts an Investor to read on.

Background – a brief review of the work undertaken to date, particularly the research and IP created.

Products/Services – a description of what the company will offer for sale including the current market and a comparison with competitor products/services. You should indicate how you will market and sell your product/service and any delivery/supply issues.

Market – you should describe the market sector in which the company will operate. You need to be able to demonstrate the size of the market and your competitive advantage.

Management – set out the skills and experience of the key people in the business (including one page CVs in an appendix). If additional management is required highlight this and indicate how you will recruit them and how they will be compensated.

Risk Analysis – explore best and worst case scenarios. Look at what the main milestones will be and how you will adjust if for any reason they are missed. Explore when you will need further funding. The Investor will always ask these questions and will be pleased if they are addressed by you.

Financial Information – include financial projections, usually at least a three year summary of the profit and loss account, balance sheet and cash flow projections. Show where the money will be spent. Say something about the likely timescales for returns on investment and the method of selling shares (called “the exit”). This is how Investors make their returns, i.e. how they turn their original sum into a multiple of that amount.

Involvement of the Research Originator

- **Your Role** – You, as an originator, will be at the centre of the spin-out from the outset. This will involve you in many roles. You are very likely to be one of the initial shareholders and you will be looking for the company to grow and develop to increase the value of your shares.

  You may be asked to chair the Scientific, Technical or Research Advisory Board of the company in the early stages of the company's life. This is conventionally classed as a committee of the board of directors. It does not necessarily mean that you have to be a director of the company to be a member of it. It is an important role, though, ensuring high understanding by the directors of the company's core competencies and any relevant issues, such as safety and regulatory issues, associated with the company's portfolio.

  You may also take a place on the board of the company as a director. The role of a director is principally concerned with the 'big picture' and strategic leadership and is distinct from a manager's role. Nevertheless, in a small spin-out company, your particular appointment as a director is likely to involve you in a more "hands on" role in the running of the company and require you to be involved in the day to day business activities of the company such as negotiating contracts, dealing with employees and managing cashflow. However keep looking at the long-term strategy of the company. Prepare plans to deal with and anticipate changes in circumstances and to attract further sources of funding so that the company can not only survive financially in the short term, but also continue to grow and fulfil its potential.

- **Conflicts** – Your involvement in the spin-out, therefore, can pull you in many different directions and place considerable demands on your time. It may also give rise to conflicts of interest. In the early stages the company may not have the financial resources to allow you to take a full-time role in it. You can, therefore, be left in a position where you are balancing your time and energies between fulfilling your research role as an employee of your institution as well as devoting time to getting the spin-out off the ground.

You need to be clear about when you are working for the spin-out company and when you are working for your research institution. This is particularly relevant in terms of having to determine who owns any IP rights which may be being developed. This is further complicated if you are using students under your supervision or your institution's facilities to work on projects related to the company. Ideally, everything should be done on an "arm's length" basis. Whilst it is not easy to resolve these conflicts in the early days of the company's life, it is important that such conflicts are declared to the Board of the spin-out company, Head of School, Centre or Department and your institution (often through the Registrar) or as set out in your institution's conflicts policy. This not only shows that you have recognised the conflicts but that they are "in the open".

- **Guidance** – From the very start, you will benefit from active guidance from a business person (often called a mentor) and from your IP commercialisation organisation. Talented, entrepreneurial managers are rare and so seek plenty of advice to find them from personal contacts of your IP commercialisation organisation, which often has an appropriate contacts database or network. There are Executive Recruitment Agencies, who are useful sources. There is also a specialist on-line agency, Directorbank (www.directorbank.com), which provides a matching service. Organisations, such as the Institute of Directors (www.iod.com), should also be able to assist.

  Try to read an entrepreneurship magazine quite frequently. It will give case studies, tips on the latest financial initiatives, information on relevant workshops and short courses. It will give you a flavour of the terminology, psychology and culture of new and small companies. The Chief Executive of your institution's IP commercialisation organisation will know lots of these and be able to recommend a suitable one.

- **Changing Environment** – You need to recognise and adapt to a changing role within the company as it hopefully grows and expands. Whilst you may have a fairly "hands on" role in the management of the company in the early days, this may be less appropriate in the future when more experienced managers with specialist skills may be needed to take the company to a new stage. If you want a continuing active role you have to be prepared to learn business and management skills and ultimately to give up your existing job or position.

Although in exceptional circumstances a researcher may continue to play a leadership role, the demands of the business and the investors often mean that you may, in time, resign from the board of directors (if you are in fact a director already) and become, say, Head of the Scientific/Technical Advisory Committee to the Board. After that, you may become an occasional consultant, so that within 3 to 5 years following the creation of the spin-out, your role may simply be that of a shareholder. Indeed, many investors will not become involved where research staff have significant management influence.

No matter what role you take or how active you are in the spin-out, you will need to appreciate that rapid and frequent changes in direction and circumstances are not unusual in a commercial environment.

Given that the research idea is novel and the market is clear, the most likely factors determining success will be the ambition, persistence, marketing skills and effective management of resources by those involved. This will be especially demanding and stretching for you if you are still carrying out duties for your research institution employer and is one of the reasons why you should be open to form productive partnerships with experienced people, who can add value to the spin-out and share your commitment and workload.

The people who become involved in the spin-out will come from many and quite different cultures. These new people will be woven in progressively as the spin-out advances through its various businesses phases. They may not always understand or be patient about your wider goals or duties as a researcher, especially if you are still employed full-time by your institution. The spin-out will be their only focus and concern. They will be more interested in the products, revenues and profits that are to flow from the IP, than in the IP itself.

Your spin-out company will almost certainly be founded on IP. It will probably be the spin-out's major asset for many years to come. IP protects your ideas in various forms. It is made up of a bundle of different rights. Some rights have to be registered to be effective; others arise automatically. The most relevant IP rights for spin-out companies from research-based institutions are generally patents (for inventions), copyright (for software, on-line content, reports etc), design rights (for equipment designs) and trade marks (for names). There is also know-how or confidential information. This is not strictly IP but will be equally important to the company.

Under which name does your company intend to trade? To protect against others using that name, consider registering the name as a trade mark in the territories in which the company will be trading. Consider the registration of domain names. For example, if the company is to have a website, then a domain name should be registered to direct customers to that website. Search against your chosen name in an internet search engine to see if anyone else is using it. It is always easier to choose a new name at this stage if there is a problem.

Due Diligence (Investigation)

The success of the company will depend largely on the successful development and exploitation of IP. Firstly, identify the IP that is required. Will the company rely on specific techniques, chemical formulae or manufacturing processes? Will the company require the use of particular software or other equipment? Will access to specific know-how be required by the company, for example laboratory note books, operating manuals or specific databases? Keep a record of all the IP that is identified.

Once identified, check where the IP has been developed. Was it developed solely by your research group or have other groups within your institution been involved? Check whether any patents have been applied for or granted. You can search for many existing patents via the esp@cenet website (http://gb.espacenet.com) or at the British Library. Check whether a patent agent is used by your institution and, if so, the relevant people within your institution can make enquiries with the agent. Alternatively instruct an independent patent agent to conduct some searches. If the company is likely to trade outside the UK, check whether there are patents outside the UK.

Searches will not only identify any patents/applications held by your institution but also any patents which are held by third parties and therefore whether the company would be at risk of infringing third party rights.

Ownership

The company is a separate legal entity to you and your institution. It must either buy the IP it needs or, at the very least, obtain permission from the owner of the IP to use and exploit it. Generally, the owner of any IP is the person who created it, unless it has been sold previously. However, there is one important exception to this position.

An employer generally automatically owns the IP created by its employees in the course of their employment, unless the contract of employment specifies an arrangement to the contrary. An employer in the UK will only hold rights in a patentable invention created by an employee if it was created in the normal course of the employee’s duties or in the course of duties specifically assigned to the employee and, in both cases the invention might reasonably be expected to result from the employee carrying out such duties. Employees of academic institutions will usually include professors, readers, lecturers, technicians, research staff, project officers, experimental officers, support staff and administrators. Students will not normally be employees unless, in addition to being registered students, they also have a contract of employment with the academic institution.

A number of research institutions have IP policies which specify contrary arrangements under which the institution, as an employer, waives its rights to ownership in certain circumstances. You should check with your IP commercialisation organisation, research administrator or Registrar to find out how you are affected in this regard.

It is difficult to trace back ownership if a number of researchers/students have been involved in the development work. Always check IP policies and relevant specific agreements to find out whether your research institution holds the rights to the IP concerned.

Consider any individuals who may have joined the research team from another research institution. Will any IP still be owned by that research institution? Consider any individuals who have left the research team to go elsewhere. Could they have taken any IP with them? Check the terms of any research collaboration agreements. Could the IP be tied up with other members of the collaboration? Is there any of the IP which may be jointly-owned? Check grant funding documents as they sometimes contain some unusual terms, where certain rights are claimed. Keep a file of all the documents which are discovered.

Once identified, the company can then enter into agreements either to buy the IP (known as an assignment) or obtain permission to use the IP (known as a licence). Registered rights should be set out in schedules to such agreements. This way it is clear exactly what is being transferred. It is more difficult to identify unregistered IP and know-how, however, you should try to record in the schedule as much detail as possible. Make reference to particular laboratory notebooks with dates, result books, papers or any other materials which you think will be required by the company in the future.

Confidentiality

If the required know-how is likely to be patentable or designs registered in the future it will be important that no prior disclosure has taken place – this could include a journal publication or presentation at a conference. If disclosure has taken place the company may be prevented from obtaining registered protection. Check whether disclosure may have occurred and, if so, were any confidentiality agreements in place? Were the agreements complied with? Take copies of any agreements located. What exactly was disclosed under them?

Future IP

The company must retain the IP developed and created by the company in the future, sometimes called “downstream” IP. You will need to ensure that all company employees have adequate IP and confidentiality safeguards in their employment contracts. Consultants are not classed as employees. Therefore, generally, IP created by a consultant will not automatically be owned by the company. Ensure that individual consultancy agreements are put in place dealing with IP ownership.

If the company is to work with your institution in the future you will need to put in place obligations of confidentiality between them.

You will also need to be clear about the arrangements with the company, since research institutions will not wish to be placed in a position where all relevant future IP automatically goes to the spin-out. This is known as a “pipeline” situation. It will expect to freeze the original deal at a point in time and come to separate arrangements about future IP.

Whilst the basic principles of protecting IP are straightforward, applying them can be very complex. Identify a person to also act as IP Manager who can be allocated various roles within the company for this purpose. Alternatively, your institution’s IP commercialisation organisation may be able to supply an IP Service for the spin-out.

If the company has any registered rights, eg patents, renewals will need to be kept up to date. You can pay for a reminder service! Adopt practices for the identification of new patentable inventions or other IP, which may arise. This could be included as a standard item at project meetings. This is very important because it is a good idea to enhance the strength of the spin-out continuously through a growing portfolio of IP.

Look around widely for other relevant or supporting IP. Do you have colleagues at other institutions with whom you could collaborate to develop IP or is there IP elsewhere which could be acquired? New patents can provide an extension in time to the spin-out’s base, as patents have a time limit (usually 20 years). Ensure that an IP strategy is a distinct and robust part of your business planning.

Set up procedures for the accurate recording of know-how in notebooks and the secure storage of information which will be confidential to the spin-out. A ‘sign-off’ system can be initiated, particularly in relation to information which is to be published.

There may come a point where certain IP is no longer required by the company. For example, the focus of the company’s research may shift into different areas. This should be constantly monitored. The company can make money by selling or permitting others to use the IP that is no longer required by the company or you can save money (eg renewal fees) by letting registrations lapse.

Check collaboration agreements, confidentiality agreements, materials transfer agreements or similar to ensure the company does not release important IP. The IP Manager can arrange regular IP training sessions to ensure all employees/workers are aware of the procedures in place. Training could also be provided to employees of the company in relation to the release of information over the internet and the use of copyright materials on the internet.

What happens if the company infringes IP belonging to a third party? This can be very expensive. It is also up to you to stop others infringing your IP. This can be equally expensive. Consider obtaining IP insurance coverage to protect against these situations. There are a number of options available and advice can be sought from a specialist insurance broker.

Company Structure

The spin-out vehicle will almost certainly be a private company limited by shares. A company is a legal entity in its own right and can enter into contracts and undertake obligations. The ownership of the company rests in the hands of its shareholders. They may also be called its members. These are the individuals who subscribe for (ie acquire) shares in the company.

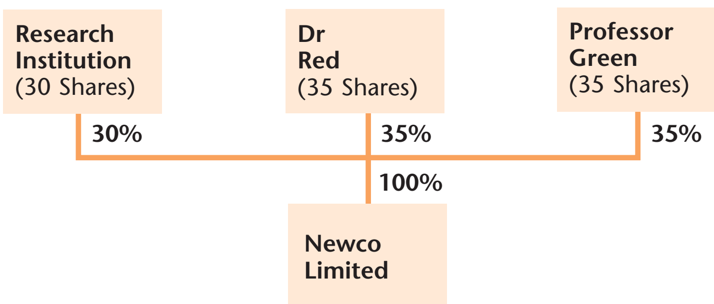
Each company may have a Company Secretary (who may also be a director), who is responsible for dealing with filings at Companies House and ensuring the company's statutory books (its official records) are kept up to date. Ask your IP commercialisation organisation if it can provide a Company Secretary service or if it can arrange for a legal or accountancy firm to do so.

The directors manage the company and may be different people to the shareholders.

Shares

The shares represent units of ownership in the company. For example, if the share capital of a company is £100 divided into 100 ordinary shares of £1 each and 30 shares are issued to the research institution, 35 shares are issued to Dr Red and 35 shares are issued to Professor Green, the ownership of the company will be as follows:

Figure 1



In other words, the researchers, as the holders of 70 of the 100 issued shares in the capital of the company, will own more than half of the company or 70% of the "equity". Whilst day to day operational control and management of the company will rest in the hands of a board of directors, ultimate control is with the shareholders. They have the power to appoint and remove the directors. The difference between shareholders and directors is explored in Section 4 – Shareholders and Directors.

The control is exercised primarily by the passing of shareholder resolutions. There are two main types, ordinary resolutions and special resolutions.

Ordinary resolution	passed by shareholders who hold more than 50% of the voting shares.
Special resolution	passed by the holders of at least 75% of the voting shares and required for certain key matters.

Types of shares

Whilst the most basic type of share is the ordinary share, a company may issue different classes of shares to which different rights may attach. For example, a company may issue a Preferred Ordinary Share which may carry a right to a preferential dividend or to enhanced voting rights. Holders of Preferred Ordinary Shares may receive a dividend whilst ordinary shareholders may not. (There is further detail on the payment of dividends in Section 4 – Shareholders and Directors).

A description of the different sorts of rights which can attach to shares is, however, outside the scope of this Guide. It tends not to be too much of an issue at the spin-out stage where the key is to keep the structure straightforward. Be aware, however, that as the company grows and looks to external investors for further loans, such investors are likely to demand various preferential rights for the shares that they will be acquiring.

You may, for example, be able to negotiate a loan or overdraft facility from a bank, which will satisfy the funding requirements of the company without having to give away any of the shares to outside investors. The commercial reality, however, is that banks are usually reluctant to lend significant sums to such start-up ventures, particularly where the spin-out company may not own any significant assets over which the bank can take security for its loan.

Liability

Another important concept for you to remember is that the liability of a shareholder is limited to the amount, if any, unpaid on his or her shares. In other words, if the company incurs a large liability or is sued by a creditor because it cannot pay a debt, the shareholders should, if they have fully paid for their shares, be immune from any such action unless, for example, they have agreed personally to guarantee any such liability of the company. Directors can also be personally liable for actions of the company (for example if they allow the company to run up debts with no hope of ever paying its creditors). If you will be taking on the role of director, you may want to consider directors' and officers' insurance at an early stage (see Section 8 – Insurance).

Documentation

So what are the key documents and concerns that are likely to be relevant when setting up the spin-out company?

- A Business Plan – this brings together the strategy and operational plans of the business proposition: it conveys the business opportunity. It should be concise. Whilst the plan details are likely to change frequently from inputs of others and from experience as the business itself develops, it is very important to be clear about the fundamental business model and the routes to market (ie who are the customers and how will they be approached?). All of the directors as a group (ie the board) must take responsibility for ensuring that the plan is a strategic document which is credible and robust.
- Heads of Terms (also styled a "Term Sheet") – these capture the headline points of agreement on the deal/arrangements, which will be developed in detail later into formal legal documents, such as a Shareholders' Agreement. They are put together to check everyone's understanding and act as a record of the deal discussions, soon after an agreement in principle is reached. They should be specifically written so as not to be legally binding, except perhaps in respect of confidentiality.
- IP Assignment/Licence – will the company own or have the right to use IP or other assets or equipment in order to conduct its business? If so, the terms of such agreements will need to be documented. Shares can be issued for such assets.

- Shareholders' Agreement/Investment Agreement (often referred to as a "Founder Shareholders' Agreement" at this stage) – this is usually entered into by the various parties. This sets out the relationship between the shareholders (ie their individual rights and obligations) and also how the company will operate and be managed.
- Articles of Association – this is a public document which must be filed with the Registrar of Companies at Companies House. The Articles essentially govern the internal workings of the company and set out the rights which attach to the shares in the company (and may set a cap on the amount of shares it can potentially issue at that stage).
- Memorandum of Association – the Memorandum of Association simply contains a statement of intention of each of the first shareholders to; (a) form a company and; (b) take at least one share in that company. This is also a public document and must be filed at Companies House.
- Employment Agreements – will you, as a researcher, be an employee or consultant of the company or seconded to it and, if so, on a part-time or full-time basis? Will the company need any other employees? Will the company have sufficient funds to pay salaries? The terms of such arrangements will need to be documented.
- Facilities Agreements – will the company require access to offices and or laboratory space? Such arrangements will almost certainly need to involve the Head of Department or equivalent and may form part of a wider services agreement with the research institution backing the spin-out. As well as providing office and laboratory space, institutions may also offer other services such as book-keeping and the production of accounts during the early stages of the spin-out's life and also access to incubator premises.

All these matters are areas on which you should get independent legal and accounting advice. There may, in particular, be tax implications and this is looked at in further detail in Section 7 – Tax Issues.

Shareholders and Directors

You may well have a dual role in the company as both a shareholder and a director.

Role of the Shareholder

Ultimate control of the company lies with the shareholders with their ability to appoint and remove directors. (There is a special procedure whereby the shareholders can vote to remove a director from office). However the vast majority of powers relating to the day to day running of the business lies with the directors.

As a shareholder in a private limited company, your liability is limited to the amount, if any, which remains unpaid on your shares. However, commercially speaking,as a shareholder you may not be able totally to avoid liability in other ways. You may, for example, be required by lenders to guarantee personallyany borrowings by the company. If you are asked to do this by a funderor supplier or any other third party, you should of course be extremely wary and take professional advice. Any agreement to give such a guarantee will mean that your own personal assets will be at risk if the guarantee is ever called.

Powers of the Shareholders

Shareholders’ powers are effectively exercised by the shareholders through the passing of ordinary and special resolutions.

MAIN POWERS

- to vote in general meetings of the company
- to change the Articles of Association of the company (the Articles govern how the company is run internally and set out the rights which attach to the shares)
- to change the share capital of the company
- to authorise the directors to allot shares in the company to new or existing members
- to elect new directors and remove existing directors.

Payment of Dividends

A dividend is effectively a payment of the company's profits to its shareholders. It is a way in which a company can distribute any profits, which it has made, to its shareholders. A shareholder does not, however, have an automatic right to a dividend. There are various rules as to whether a dividend may be paid, in particular the availability of distributable reserves (ie profits which the company may distribute to its members).

The directors of the company will usually recommend to the shareholders what dividend, if any, should be declared by the company. Shareholders must then vote on whether it should be declared and whether the dividend should be less than that recommended by the directors. Shareholders are not usually permitted to declare higher dividends than those suggested by the directors.

Usually the payment of dividends tends not to be relevant at the spin-out stage, as many spin-out companies may not produce any profits for some time. In other words, there are unlikely to be surplus distributable reserves for the payment of dividends during the early stages of the company's development. In any event, the goal in relation to a spin-out is usually to sell the company within five years or so of its formation in order to make a capital gain so that founding shareholders are not so interested in receiving an income from dividend payments.

Role of a Director

The main difference between the directors and the shareholders of the company is that the directors are responsible for the day to day management of the company and as such are answerable to the shareholders. The directors are also subject to various obligations and duties, which are intended to protect the position of the shareholders in a company in which they may have little, if any, day to day involvement. The Institute of Directors runs courses around the country for aspiring directors as well as discount schemes for things like insurance (see section 8).

The directors are effectively the agents of the company. Together they form the board of directors of the company through which the strategic management of the company will be conducted. Regular board meetings of the company will need to be held. The directors will be required to review the financial position of the company and its ability to meet its obligations going forward. It is the board of directors, who collectively make all the decisions relating the management of the company.

If you become a director of the company, you will need to file information about yourself, which will be held on a public register at Companies House (www.companies-house.gov.uk). The information is submitted on a statutory form and will include details of your address and any current or former directorships.

Shadow Director

Even if you are not appointed as a director you could, as a result of your actions, be a “shadow director”. A shadow director is someone whose directions or instructions the appointed directors of the company tend to follow. If you attend the spin-out board meetings regularly and/or instruct the directors, it is possible that you may be considered to be a “shadow director”. This means that, in law, you will have all the responsibilities and liabilities of an appointed director. Therefore be clear about your position.

Your institution may also be deemed to be a “shadow director” if the spin-out board is inclined to follow instructions from the institution’s representative. So be conscious of your institution’s need to have a distinction between its role as a shareholder and important stakeholder, compared to being seen as controlling the spin-out on a management basis.

Executive and Non-Executive Directors

The members of the board of directors will comprise a mix of executive and non-executive directors. An early stage spin-out may have more non-executive directors than executive directors. The opposite will tend to be the case for later stage companies. The executive directors will hold a specific role and have a key function in terms of the management of the company, such as that of Managing Director (sometimes called the Chief Executive), Finance Director, Operations Director, Technical Director and Sales Director. However, they are required to act in a strategic and overall capacity when contributing at board sessions. As a director, you are also expected to deal with areas outside your operational/functional responsibilities on these occasions. The executive directors will usually have service contracts which will set out the terms on which they are employed by the company such as the period of notice and salary.

At least one non-executive director may be appointed by the Investor backing the spin-out (often referred to as the Investor Director or Institutional Director). This could be someone who is not employed by the Investor, but someone who is chosen for their relevant expertise to complement the other directors. In general such an appointment is termed a Nominee Directorship. Non-executive directors do not have a specific management role within the company but generally have a good deal of commercial experience and so can provide general skill, advice and external contacts and networks to the board. Non-executives do, however, owe substantially the same duties to the company as executive directors. They are expected to carry out their functions with skill and care and owe the same range of fiduciary duties to the company as executive directors. The statutory provisions that apply to directors make no distinction between executives and non-executives. The non-executives will usually have a letter of appointment setting out their role and payments.

Non-executive directors will often be active in dealing with matters such as audit reviews and remuneration so that they can bring independent judgement to some of the company's key areas. Usually the Chairman of the Board will be drawn from the non-executive directors and ideally this is a role not to be combined with that of a Managing Director, in order to provide balance and objectivity in the leadership of the company.

Directors' Powers

The directors are granted their powers by the Articles of Association of the company. The Articles usually provide the directors with the power to manage the business of the company and to exercise all the powers of the company itself.

In addition to the actual powers granted to the directors under the Articles of Association, directors may have "ostensible" or "apparent" authority when dealing with third parties, due to their position as a director. A director will bind the company if he or she enters into contracts with actual or apparent authority, regardless of whether he or she did in fact have such authority. If a director purports to enter into a contract with a third party, the director may be personally liable to that third party for any breach of warranty of authority. Therefore, as a director you must ensure that when you enter into a contract you not only have authority from the company to enter into it, but also that you are clear that you are acting on behalf of the company and not personally.

The decisions made by the board of directors are usually taken on a majority voting system. If there is an equal number of votes, the director nominated as chairman of the board of directors may have a casting vote to determine the matter.

The chairman is in theory nominated by the other board members. In practice, where third party funders are involved, it is likely that the funder will insist on the right to appoint the chairman. The basic position, however, is that, regardless of how or by whom a director is appointed, he or she owes his or her first duty to the company. Directors should be chosen for their relevant expertise and strategic-thinking abilities.

Directors' Duties

Extensive duties are imposed upon the directors of all companies. Directors' duties are owed by each director individually. Directors must act in the company's best interests (ie make corporate decisions properly). This typically affects the directors as a body. They must all actively participate in the decision-making process and not attempt to abrogate their responsibilities.

DIRECTORS' DUTIES

- To exercise independent judgement.
- To exercise reasonable care, skill and diligence.
- To avoid conflicts of interest.
- Not to accept benefits from third parties.
- To declare any interest in proposed transactions or arrangements.
- To promote the success of the company.
- To act within their powers.

Certain other rules also affect directors. The main things which directors have to have regard to are:

- the long term consequences of a decision.
- the interests of the company's employees.
- the need to foster relationships with suppliers, customers and others.
- the impact on the community and the environment.
- the desirability of the company maintaining a reputation for high standards of business conduct.
- the need to act fairly between members of the company.

There are also rules about the making of loans to directors. Certain transactions with directors need to be approved by the shareholders, such as the acquisition of an asset from a director. Directors have to comply with certain internal management issues such as the keeping of accounting records, preparing annual accounts, filing documents with the Registrar of Companies and keeping the statutory books of the company.

Wrongful Trading

The duties on a director are particularly important in situations relating to the potential insolvency of a company (ie where a company has to cease trading because it can no longer pay its debts). A director must act if he or she knows or ought to conclude, that there is no reasonable prospect of the company avoiding insolvent liquidation. This takes account of the director's general knowledge, skill and experience. The director must advise the board of the insolvency and ensure that every step is taken to minimise the loss to creditors.

If the director fails to do so he or she may have to pay personally into the pool of assets to be paid out to creditors of the company.

Penalties

A director can, therefore, be liable to the company as a result of his/her wrongdoing. These acts may be punishable by financial penalties payable to either the company or third parties and, in some cases, criminal penalties. In addition, where the company is insolvent, a director can be disqualified from acting as a director for a period of time.

A court may relieve a director, wholly or partly, from liability to the company (but not to third parties) if it appears to the court that the director has acted honestly and reasonably and that, having regard to all the circumstances of the case, the director ought fairly to be excused. A director may, for example, be excused for relying on advice which turns out to be wrong. A director is not excused where the breach would have been avoided had legal or other professional advice been sought.

The duties, expertise and responsibilities of a director are therefore clearly very serious (as compared eg to a shareholder) and should not be treated lightly. It is more than a title.

HOW TO BE AN EFFECTIVE DIRECTOR AT THE START-UP STAGE

- Work collectively in a team environment with your fellow directors and provide leadership.
- In a start-up situation there will be a blurring of roles because there are many things to be done with few people and resources, but even in the busy and demanding times it is important to be clear about the distinction between executive and non-executive directors so as to have independent views and governance available to the company.
- Take time out to think strategically and overall rather than always sticking to the comfort zone of your research area and becoming engaged on operational matters and reviewing past performances – it is vital to look forward constantly and across the whole business.
- Be clear about the company's mission and ensure regular and appropriate dialogue and performance reporting with the shareholder and stakeholder bases in a coordinated, effective and even-handed way.
- Be conscious of the importance of risk management assessments of the business, particularly cash management (always have the ability to meet the company's bills) and health and safety (welfare of staff and customers/visitors).

Funding

Your spin-out company will not succeed without finance. This can come from various sources. Some may come in kind, such as the provision of premises for a limited period, say, by your institution but the most telling type of funding will be money. You may be in a position to provide some financial backing yourself or you may have family and friends who are willing to support you with funds. However, bearing in mind the hundreds of thousands of pounds required to launch and develop a successful company you will almost certainly need to turn to external sources of funding. These will be your Investors.

Investors put in cash for a return. As your company will be new it is a risky investment for them and so they expect to receive a large return. Investors have different expectations to you. They are looking eventually as to how they will exit from your company and make their money. Your IP commercialisation organisation will be able to help you find suitable investors.

Typical Investors

- Your research institution
- Early-stage funders and specialist IP investing companies, eg University Challenge Fund, Regional Enterprise Fund and Seed Funds
- Business Angels
- Venture Capitalists.

Funding

Research Institution

It is likely, though not always the case, that the research institution will take a significant shareholding in exchange for various things such as, IP rights, infrastructure contributions, general support, use of research institution name/association. Sometimes this shareholding will be held on behalf of the research institution by its IP commercialisation organisation. Sometimes the research institution will invest cash at the start-up stage mainly for proof of principle purposes or to match or attract a first/early Investor. The research institution will frequently expect to have good information about its own spin-out company activities and this is achieved either by including certain obligations for this provision in the Shareholders' Agreement and/or having a representative on the spin-out board – quite often it will nominate someone with market experience of the spin-out's activities but sometimes it will nominate a member from its IP commercialisation organisation's board.

Early Stage Funders

As with the research institution itself, the University Challenge Fund and other dedicated early stage investment funds set up by external investors will expect similar rights to the research institution. As many Challenge Funds are set up as separate investment vehicles (although owned by a university), this can result in a separate (additional) shareholding to that of the research institution.

Whilst both the research institution (acting through its IP commercialisation organisation) and the Challenge Fund are interested in realising a capital gain by selling their shares, it is unlikely that they will be active in managing the spin-out or being a board member beyond about two years from the creation of the spin-out, by when they are likely to have been replaced by experienced directors and professional managers (but they will still retain their shareholding).

At times these early stage funders like to co-invest with a number of similarly structured funds as a consortium and one will be chosen to handle most of the negotiations ("the Lead Investor").

Business Angels

These individual investors are likely to be interested in spin-outs because of the opportunity to receive a significant shareholding in exchange for taking a large personal financial risk at the early stages of a company's life. As entrepreneurial characters and busy people, who are probably backing a number of businesses, they are not likely to want any management role nor any Board involvement but often they do like to reassure themselves about the energy and commitment of the people involved, inject ideas and operate informally by introducing contacts for further investment or business opportunities. Hence, business angels are not usually in a structured relationship with the spin-out. However, not surprisingly, they will be very interested in how their money is to be used and it is common for "angels" to reassure themselves that reasonable salary and option schemes are in place (eg by seeing copies of employment and service contracts) and to receive updates from time to time.

The British Business Angel Association (www.bbaa.org.uk) is a good way to get in touch with these "angels". Another useful source is the Enterprise and Business Support (www.bis.gov.uk/enterprise).

Venture Capitalists

These are specialist finance providers, who are interested in very good returns on their investment, and often have minimum criteria regarding an investment, eg the company must have already achieved a certain stage, the management must have a track-record of success and the company must have minimum potential scale of returns and operate in specific market sectors or technology areas.

Often the finance to be invested will be provided on the achievement of agreed goals, called 'milestones'. So, if certain stages are not reached or tasks not completed satisfactorily, then the next amount of finance is withheld. This is often referred to as 'drip-feed' investment.

Venture Capitalists also require stringent examination of the status of IP rights and of existing or pre-existing situations regarding the work and its people involved (the due diligence process). They will usually expect the existing shareholders to provide warranties as to the accuracy of information and the IP position of the company.

As they are putting in hard cash, Venture Capitalists (and Business Angels) will be keen to see you put in some cash too. This is called “hurt money”. It gives the Investors additional confidence that you will be fully committed to the venture and not see it merely as a modification of your research activities. They will expect you to see all of your money going into, and hence your reward coming from, your shares. For this reason they will not support you receiving significant (or even any) consulting fees. This is viewed as taking out money ahead of everyone else (especially them). They are looking to the increase in share value as their reward. They want everyone to be in the venture together, pulling in the same direction.

This requirement for detailed target goals (milestones) and the examination of status can mean that the Shareholders’ Agreement will be very detailed and lengthy. As with Business Angels, the Venture Capitalist will not be interested directly in the running of the company, but will be keen to assist the company by providing contacts and information. However, it is likely that a Venture Capitalist will expect to constrain many of the freedoms of management to act without consultation or approval and also to have a say in the membership of the board.

One way to contact Venture Capitalists is through the British Venture Capital Association’s website (www.bvca.co.uk), which has a keyword “matching facility” for identifying relevant Venture Capital firms against your funding level requirement and field of business activity.

Dealing with Investors

Although it is not necessarily the case that all four types of investor will be involved in any one spin-out, it may well be the case. So, by the time that a Venture Capital firm has invested, in addition to the research originators, there could be four new “groups” of shareholders and an entirely new and complex set of documents (eg new Articles of Association, new Shareholders’ Agreement) produced compared to when the company was first established.

Of course the interaction and negotiations involved with each of these four is complex and you would benefit from taking experienced advice along the way. Your institution will probably have a published policy detailing the allocation of shares as between you and the institution. Its IP commercialisation organisation will be experienced in finding and negotiating with any third parties, if the spin-out has not yet appointed its own manager/director. However, it should always be remembered that the IP commercialisation organisation acts as an agent in the best interests of its institution and so you, as a researcher, will need independent advice about your rights, personal commitments and negotiating position.

The next stage

The aim of all those involved in the spin-out company is to grow the business so that the value of the company and the value of the shares held by the shareholders increases. Indeed, the ultimate aim of any Investor will be to realise the value of his/her shares by seeking what is commonly referred to as an exit usually by:

- the sale of all the shares in the issued share capital of the company to a third party, usually a trade buyer (known as a trade sale); or
- the listing of the company's shares (commonly named a listing, a flotation, going public or an Initial Public Offering (IPO)) on a recognised investment market eg the London Stock Exchange (LSE) or the Alternative Investment Market (AIM).

Before the company has grown to the stage where an exit is possible, however, it is likely to require further funding. Whilst this funding may come from existing shareholders, it is more common for spin-out companies to seek funding from external funders. This may be from Business Angels or Venture Capitalists.

As the new Investor will become a shareholder in the company, a Shareholders' Agreement will still be relevant. However, as mentioned earlier, the Investor is likely to have its own standard form documents which it will expect to form the basis of the new agreement and which will replace the agreement entered into when the company was first getting off the ground. This is likely to contain provisions which are more onerous than those expected at the spin-out stage. This is particularly so in relation to the following areas:

- **Warranties** – in deciding to commit funds to the project, the Investor will want comfort that the management team is prepared to stand behind the key information documents on which it will have relied when deciding to invest. This will relate in particular to the business plan and due diligence reports relating to the company. Try to negotiate limitations to limit your liability in such circumstances such as a maximum financial cap on your liability. Be wary also as to the nature of any warranties which you will be giving and whether you are being asked to warrant the future performance of the company. You should also disclose any matters which make the warranties untrue by preparing a Disclosure Letter for submission to the Investor. If, for instance, there is a warranty that the company is not involved in any litigation but you are aware that the company is being sued by a creditor, you should inform the Investor of this through the Disclosure Letter.

- **Consent Matters** – the list of consent matters is likely to be far more extensive than those expected at the spin-out stage. Whilst there is still a balance to be struck between operational flexibility for the management team to run the business effectively and the controls required on them by the Investor, the Investor will potentially be committing a sizeable amount of funds to the company. The Investor will be keen to know, therefore, that the scope for the management team to fritter the money away on matters that take value out of the company is limited (eg the management team awarding themselves large bonuses or expensive new company cars without the consent of the Investor).

- **Information** – The Investor is likely to require more detailed information than that required at the spin-out stage. For example, as well as the monthly management accounts, reports may also be required as to current trading, revised forecasts and the performance of the company against financial covenants contained in any banking documents. Consider the practicalities of being able to produce the required level of information within the timescales expected by the Investor.

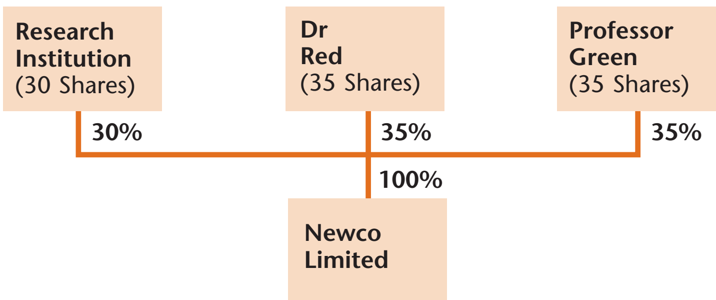
- **Restrictive Covenants** – The Investor will expect the key members of the management team to give their full time and commitment to the company to deliver the growth forecast in the business plan. It will also expect that any employees who leave the company will not set up in competition against it for a period of time after the end of their employment. The period of restriction under an Investment Agreement is likely to be between one and three years. A period in excess of 12 months under a service agreement is not likely to be enforceable.

- **Good and Bad Leaver** – If you cease to be an employee or director of the company (eg if you leave the company), you may well be required to serve a transfer notice in respect of the shares held by you (ie offer them for sale). The price at which you may sell those shares may be governed by the circumstances in which you leave the company. The negotiations with the Investor as to what constitutes a good leaver can therefore be protracted.

Reduction in Original Shareholding (Dilution)

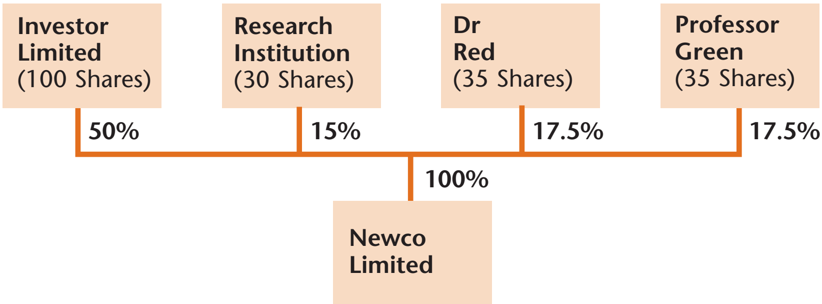
The main effect of new investors becoming shareholders, however, is that new shares will be issued to them which will dilute the shareholding of the original shareholders, including yourself. For example, if 100 shares are in issue of which you hold 35, you will own 35% of the company. If a further 100 shares are issued to new investors, you will only hold 35 shares out of 200 shares in issue, that is, you will own only 17.5% of the company. Taking the example in Figure 1 in Section 3 – Company Structure, the original position was as follows:

Figure 1



If a new investor, Investor Limited, wishes to acquire 100 new shares in Newco, the new shareholdings will be as follows:

Figure 2



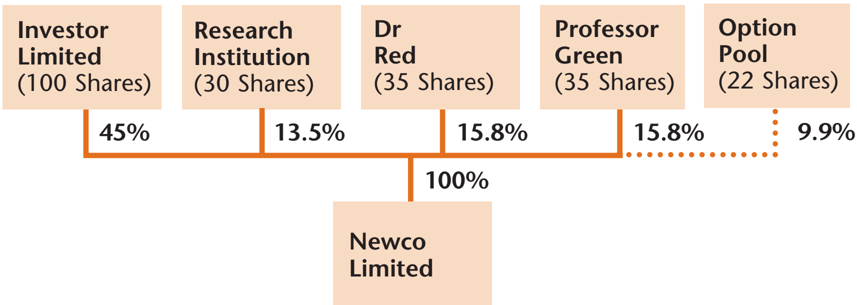
In other words, the percentage shareholdings of the original shareholders will also have gone down. They will have each suffered dilution. The question for the original shareholders, however, is what benefits the new investment will bring in return for them suffering the dilution of their shareholdings. Will the investment, for example, provide the injection of funds which the company needs to take the next step in its development?

You must also remember that the company may require a number of rounds of further financing in order for it to develop and grow until it reaches the stage where an exit can be contemplated. These rounds are classed by letter, ie "A" round, "B" round, "C" round etc. This simply means the various stages reached, ie first round, second round, third round etc, as the spin-out progresses and achieves its predetermined targets. Typically the size of funding is larger at each subsequent round and the shares issued for these rounds may carry different rights. Such further rounds of financing will inevitably lead to further dilution.

It is good practice to reserve a certain number or percentage of shares for key people who are yet to join the spin-out, who will help drive the spin-out towards success. An equivalent to about 10% of the issued shares of the company is commonplace. It is called an "option pool" and when the shares, which have nominally been allocated to such a pool, are allotted it too will lead to dilution.

If Newco wishes to allocate 22 new shares to an option pool (to create the equivalent of 10%), then the new shareholdings, once those shares have been issued, will be as follows:

Figure 3



Ultimately it is more worthwhile for you to have a small piece of a large pie than having a large piece of a small pie which has no value at all, which could be the outcome if you resist further investment because of the dilution effect.

It will also throw up the question of the valuation of the company at each new funding with terms such as “pre new money valuation” and “post new money valuation” being used by potential investors.

Settling on a valuation will obviously be important as the company will be seeking to extract as much money from the Investor in return for giving away as little of the equity as possible. The Investor, on the other hand, will be arguing for as large a percentage shareholding as possible. There will be many complex factors involved in fixing on an actual valuation (not least the question of what the Investor is prepared to pay for the shares!) and the company will need to seek the advice of corporate financiers at such time.

Remember also that these funds will be for the company to finance specific projects, to recruit sales and marketing personnel or for application generally in its development and not to be returned into the hands of the shareholders. The benefit will come to the shareholders when the company has grown to the stage where an exit is possible and they can hopefully sell their shares at a considerable profit.

Company Documentation

Once the structure of the company has been settled and it has been decided how many shares each party will have and funding secured, the next stage is for such agreement to be documented. This is normally done through a Shareholders' Agreement and the Articles of Association of the company. This section sets out briefly some of the usual provisions which are found in such documents.

The key point to bear in mind throughout is the purpose of the documents. At the most basic level, they are a record of how the relationship between the parties is intended to function in terms of the operation of the company (ie the obligations and the rights of each party). However, the documents also protect the Investor's investment. These matters are looked at in greater detail below.

Shareholders' Agreement

At the most basic level, the Shareholders' Agreement is the document which sets out the terms on which the parties will subscribe for shares in the company (eg the number of shares for which each party will subscribe and the price which must be paid for such shares). It also sets out the main terms of the arrangements between the shareholders and as to the conduct of the affairs of the company following completion of the investment. These will be aimed at providing various protections for an Investor and will usually cover the following areas:

- Information – An Investor will require management and financial information so that it may monitor the progress of the company. The Shareholders' Agreement is likely to specify the provision to the Investor of a monthly management accounts pack and statutory accounts, together with minutes of all board meetings and shareholder meetings and such other information concerning the business as it may reasonably request. An Investor also usually requires the preparation and agreement of formal financial budgets for each financial year of the company, which the Investor must approve in advance. Such information is required by an Investor primarily so that it can fulfil its responsibility to monitor its investments. If there appear to be problems in the business, it can intervene and offer guidance to the management team at an early stage to help get the business back on track.

- Investor Director – A significant Investor will usually want a right to appoint (and remove) a representative to the Board. The Investor Director may have enhanced voting rights eg if the company fails to pay any fixed dividends on the due date or if the company has done things which it is prohibited from doing without the Investor's consent. This is not usually sought, though, if the Investor holds a majority of the shares. A fee, payable by the company, is commonly charged for the Investor Director's services. How much this is and how it is arranged can vary widely. At the spin-out stage, this may be dealt with under the terms of a separate services agreement between the Investor and the company. The Investor may also be providing accountancy and administration services to the company, while it gets off the ground.

  An Investor may require the attendance of the Investor Director for a board meeting to be quorate. In this way it will be able to monitor what decisions are being made by the board and provide direct input into the making of such decisions.

- Observer – Routinely, instead of a director, the Investor will expect to be able to have someone attend all board meetings, who may or may not have the right to participate in discussions, but will not be able to vote.

- Restricted Acts – An Investor usually stipulates certain matters which the company will be restricted from doing without the Investor's prior consent.

In other words, the Investor is seeking to protect the value of its investment by preventing the company from doing fundamental things without its consent.

SPECIMEN RESTRICTED ACTS

- issuing shares in or options over shares of the company, or altering rights attaching to those shares;
- increasing borrowings over pre-agreed levels, making loans, or giving guarantees;
- changing auditors, accounting reference date or registered office;
- changing the constitution or the business of the company;
- selling or letting assets which form a material part of the business;
- entering into contracts or acquiring assets above a pre-agreed value;
- hiring and firing employees (or at least senior employees), appointing and removing directors or agreeing remuneration levels;
- creating or acquiring subsidiaries;
- diverging to any material extent from any agreed financial budget.

The company's management team may be restricted from competing against the company. This may include not recruiting the company's staff or customers for a period of time following the date on which they cease to be employees and/or directors of the company. These restrictions may not be asked for at the spin-out stage, especially if you are remaining as an employee of the research institution, but they may be asked for later, particularly when outside investors become involved.

An Investor is likely to want warranties from the management team about key matters. These may cover areas such as information in documents on which the Investor has relied in making its investment in the company, such as a Business Plan or an Accountant's Report, key areas of the business and the personal good-standing of the management team. Warranties are not always sought at the spin-out stage but it is important to be aware that you may well be required to give warranties when external investors commit funds to the project.

Given the financial risk of being sued under warranties, the management team will normally seek to limit their liability under the warranties by setting a threshold before a claim may be brought and a time limit within which a claim must be brought. It is also usual for each manager to cap his/her personal liability at an agreed amount eg an amount equal to three times his/her annual salary.

You should also bear in mind that the Shareholders' Agreement which you agree at the outset of the spin-out's life will almost certainly be superseded as new investors become involved and new funds are provided to the company. Different venture capitalists, for example, tend to have their own forms of Shareholders' Agreements which they will usually insist on using when making an investment.

Articles of Association

The Articles set out the rights attaching to each class of shares in the company. The Investor may subscribe for a different type of shares to the management team. The Investor's shares will often carry preferential rights.

INVESTOR'S PREFERENTIAL RIGHTS

- to dividends
- first return of capital
- enhanced voting rights

The Articles usually stipulate certain matters which require the Investor's prior consent (see 'Specimen Restricted Acts'). The advantage of setting such matters out in the Articles is that the Articles are a public document and third parties will be aware of the need for such consents.

The Articles will usually also include the Investor's right to appoint (and remove) an Investor Director and will specify the quorum for board meetings, including whether the Investor Director must be present for a board meeting to be quorate.

The Investor will usually insist on restrictions on the ability of the members to transfer their shares in the company.

Permitted transfers

These can be made without the need to offer to transfer shares first to other members. They commonly allow transfers within the same group of companies, to immediate family, family trusts and with Investor consent. (NB Provision will almost certainly be made for the compulsory transfer of such shares where a permitted transferee no longer has the relationship that makes it a permitted transferee. A common example of this is where a transferee subsequently leaves the transferor's group). At the spin-out stage, it is often simpler to prohibit any transfers by individuals without Investor consent.

Compulsory transfers

Even as a researcher founder/company founder in some cases you may be required by the Investor to offer your shares back to the company or other shareholders if you cease to have any material association with it. (The value of your shares may be determined by an independent assessor, such as a corporate finance accountant.) Sometimes the Investor may agree that this requirement can be reduced or waived if you are a founder and have spent a good length of time with the company following the investment. Compulsory transfers are triggered if, for example, a shareholder ceases to be an employee and/or director of the company. The basis for calculating the sale price of shares on a compulsory transfer must be fixed by the Articles. It may be based on the performance of the relevant employee or director or the length of time he/she has served.

Performance-Based Test
Distinguishes between good leavers and bad leavers (see also page 35). If a member of the management team is deemed a good leaver he/she may expect his/her shares to be valued at the higher of market value and the original cost of his/her shares. A good leaver will be defined but usually relates to when he/she ceases employment because of death, permanent incapacity or retirement at the normal retirement age. If he/she is a bad leaver (ie not a good leaver) he/she may only get the lower of market value and the original cost of his/her shares.

Time-Based Test
Provides that if a member of the management team ceases to be employed by the company before an agreed date (irrespective of the circumstances) his/her shares will be valued as if he/she were a bad leaver, whereas if he/she leaves after the agreed time period he/she would always be deemed a good leaver.

General transfer mechanism

The normal way to transfer shares involves the serving of a notice of intended transfer on all other members. They get an opportunity to acquire the proportion of them which is equal to their current proportionate holding of shares in the company. There will also be a pricing mechanism.

Exit arrangements

Exit arrangements may be covered by the Articles. Two issues which are usually dealt with are drag along and tag along rights.

Drag Along
A “drag along” provision compels a shareholder to sell, where an offer has been received from a third party for a specific percentage of the equity share capital of the company. That percentage is usually a controlling interest. Such a provision can stop an uncooperative shareholder frustrating other members from realising their investment or seeking a disproportionate share of the proceeds as a “ransom” position. These are sometimes known as “come along” rights.

Tag Along
A “tag along” provision, in simple terms, provides that a shareholder who has received an offer for his/her shares must also obtain the same offer for the other shareholders in the company. They must give all shareholders the opportunity to exit at the same time (and at the same price) before being able to sell his/her shares to that third party. This is particularly important for shareholders with relatively modest percentage holdings as, without tag along rights, they could simply be left holding shares, whilst the controlling parties sell their shares. These are also sometimes confusingly known as “come along” rights.

Tax Issues

There are various potential taxation issues which may arise upon the establishment of a spin-out company.

Income Tax on the Acquisition of Shares

It is common for you, as a researcher, to acquire shares in the company. It is likely that the Inland Revenue will consider that such shares have been acquired by reason of your employment (either with the company or with the sponsoring research institution). As a result, you will be considered to have received a benefit from your employment, which will be subject to income tax if the market value of the shares acquired by you exceeds the amount paid by you for such shares.

The risk of an income tax liability will be increased where assets and cash have been injected into the company by the Investor and/or the research institution. The assets and cash may cause the shares to have a value in excess of their nominal value. Fortunately in the case of many researcher shareholders the value of any IP transferred is ignored.

A charge to income tax will only arise if the amount you pay for the shares is less than their market value. If you are going to be contributing cash and/or assets to the company, you should ensure that these are used as payment for your shares. The Investor/research institution may receive shares with enhanced class rights, in which case it may be possible to argue that the value of the shares received by you is lower. If you pay nothing or only a nominal amount for your shareholding, you need to check if you may have to pay income tax.

Future Charges to Income Tax

Restricted shares are shares which, at the date of acquisition, are subject to restrictions which have the effect of reducing the value of the shares. The restrictions may affect the ability to retain the shares (for example, “compulsory transfer” provisions in the Articles of Association which oblige a departing employee to sell his/her shares) or the general rights attaching to the shares (for example, restrictions on transfer, dividend rights or voting rights).

If the shares which you, as a researcher, acquire in the company are "restricted shares" then you may be subject to a charge to income tax in the future. If you derive any financial gain from your shareholding, the overall effect of the "restricted share" legislation is to increase the proportion of such gain which falls within the charge to income tax rather than capital gains tax. A higher rate tax payer pays income tax at a current rate of 40%, whereas, although a higher rate capital gains tax payer still pays tax at a current rate of 40%, taper relief and the annual exemption may significantly reduce the overall effective rate of tax.

A future charge to income tax on restricted shares may arise when the shares are sold or the restrictions attaching to the shares cease to apply. A proportion of the value of the shares at this point in time may be subject to income tax. Such proportion is equal to the proportion of the market value of the shares which has been affected by the restriction or restrictions.

If you are acquiring restricted shares you should seek specific legal advice. In particular, it is possible for an employer and an employee jointly to elect that the shares are deemed not to be restricted for the purposes of the tax legislation. Whilst such an election may increase the initial charge to income tax on the acquisition of the shares, it should mean that you only pay capital gains tax when the shares are sold or when the restrictions cease to apply.

Share Options

The issuing of shares in the company at nominal value (as described above), involves giving away an equity stake in the company immediately. This may not be suitable in all situations as it can lead to dilution in control of the company.

An alternative is to use share options. A share option granted to an employee will give the employee the right at a future date to acquire a specific number of shares in the company. This may be upon the occurrence of a certain event, eg a sale or takeover of the company. This will have the benefit of incentivising the employee without actually giving any of the equity away immediately. In other words, if the employee leaves before he or she is entitled to exercise the option the option will lapse and there will be no question of having to get the shares back from him or her. Certain types of share option can be particularly tax efficient.

WHY USE SHARE OPTIONS?

- to attract key employees to the company and encourage them to remain with the company
- to incentivise employees (eg an option will only be exercisable if performance targets are met)
- to provide benefits with modest direct cash costs to the company – useful for spin-out companies

Tax and the Company

The company itself is a separate legal entity and taxed separately. It pays corporation tax on its profits. These are calculated by reference to the company's accounting period, which is established when the company is formed. It is calculated on the basis of a self-assessment tax return, which has to be submitted within 12 months of the end of the company's accounting period. In the early days (possibly for several years) the allowable expenses of the company will be more than its total turnover and so it will have tax losses rather than profits. So no corporation tax will be payable.

Companies conducting R&D in the UK can get an R&D tax credit if they are in profit and paying tax. There are credits available to some loss-making companies. The rules are complicated, for instance not all R&D qualifies for the R&D tax credit. You should get advice from specialist tax advisers to make sure your spin-out gets the full benefit.

The company will also need to deal with things such as payment of PAYE and NIC in relation to its employees. It is also important that the company registers for VAT. HM Revenue & Customs' website has guides to assist (www.hmrc.gov.uk). You should ensure the company has appropriate bookkeeping and accounting support to ensure full compliance.

Insurance

A company may take out insurance to protect itself against the financial consequences of loss of or damage to assets employed or liabilities incurred in the course of business. The insurance arrangements of a new company will frequently be driven by Investors, who may insist that appropriate insurance arrangements are put in place as a precondition of their investment.

Some types of insurance, ie employers' liability and third party motor liability, are compulsory. Other types, such as public and product liability or material damage, may also be required. Any company should, at an early stage, compile an inventory of its assets and potential areas of exposure to liability and obtain professional advice as to the appropriate level of insurance protection required.

"Keyman" insurance

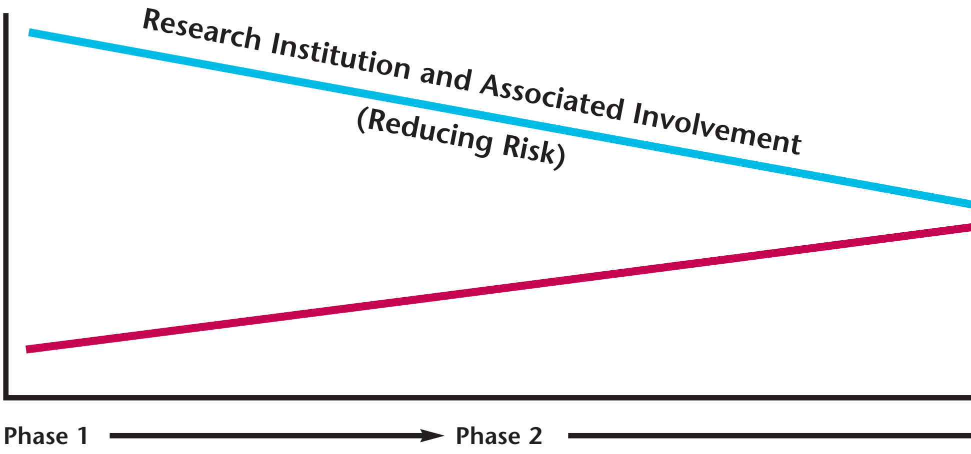
"Keyman" insurance is available to cover the costs of incapacity, illness or death of prime movers in the spin-out, such as the chief executive or a key researcher, as these individuals are very important to the company, especially when it is young. Normally Venture Capitalists will insist that the spin-out obtains this insurance.

Directors' and Officers' insurance

Of particular interest to directors of any spin-out company is Directors' and Officers' insurance, often referred to as "D&O cover". This is designed to protect directors and officers of a company from loss resulting from claims made against them in relation to their duties as directors or officers. A standard policy usually provides cover for companies for amounts, which the company pays in indemnifying its directors and officers in such situations. It also provides cover directly to individual directors and officers for losses which they incur as a result of claims made against them and in respect of which the company does not indemnify them. Insurance will not cover criminal liability.

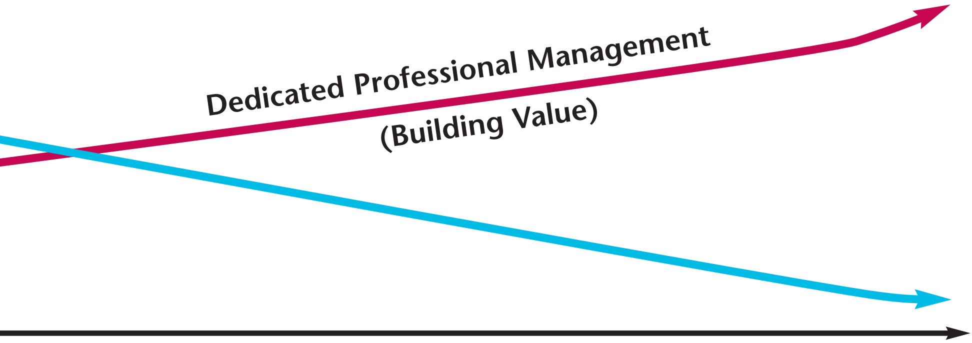
Any Directors' and Officers' policy needs very careful scrutiny before it is taken out, to ensure that it provides adequate protection against the risks to which the company's directors and officers are exposed.

Snap-shot of the Process and Steps Involved in Research Institution Spin-outs



Activities
Packaging the Offering
Patenting/IP Rights
Further Proof-of-Principle
Marketing Testing
Prototyping
Project Planning
Company Formation
Shareholders' Agreement
Memorandum and Articles of Association
First Directors Appointed
Consultancy Contracts
Development
Business Planning
Users/Customers
Forming Partnerships
Project Management
Networking
Financing
(Business Angels/University Challenge/Early-stage Funds)
Market Testing
Insurances
Consultancy/Service Contracts
Incubation Premises

The funding timescales and routes to market differ from case to case but particularly so in fields such as drug discovery in that they often take much longer than other IP commercialisation activities and face greater regulatory hurdles.



Phase 3 → **Phase 4** →

Founders and Early investors
Exit goal (5-7yrs from start)
via eg a trade sale, management buy-out (MBO), IPO.

Early Trading
Board Reconstruction
Service Contracts
Financing
(Business Angels, Consortia, Funds)
Marketing
Investment Agreement
Service Contracts
Business Contracts
Financial Direction & Accounts

Drive for volume sales and profits
Business Premises
More Financing
(VC's, Investment Banks, Private Equity Firms)

The funding process is like a relay race, in that there are a number of distinct phases where different funders are willing to participate. So there is a number of "equity gaps" and the baton can be dropped at each phase. It is important, therefore, to think ahead and to try to arrange a smooth handover. Likewise, there are different people skills required at the various phases and, so, "talent gaps" can appear. So it is vital to have access to good networks of business and marketing people. This requires constant management and is a very dynamic process. It is just as critical to success as the quality of the spin-out's technology, product or service.

Glossary of Common Terms

Articles of Association – These form the constitution of the company. The Articles essentially govern the internal workings of the company and set out the rights which attach to shares in the capital of the company.

Bible of Documents – This is simply a set of copies of all the signed documents for a transaction bound together or in a looseleaf folder or on CD, usually with an index.

Business Angels – High net worth individuals, who are seeking early stage companies in which to invest with a view to making a large capital return.

Business Model – The road map which gives an overview of the business proposition and how it will be achieved and sustained.

Business Plan – A Business Plan typically includes financial projections and market information relating to a company and will be one of the principal documents which an Investor will rely on in deciding whether to invest in a company.

Chairman or Chair – The director appointed by the board of directors to act as its chair(man). In practice it is a position of great influence. He/she will be involved in determining the agenda for each board meeting and ensure that the board operates in an efficient manner. In public companies the chair(man) is expected to be someone different from the Chief Executive/Managing Director and this is widely mirrored in spin-out companies.

Chief Executive or CEO – This is a term for the director of the company who has overall day-to-day responsibility for the management of the company. Another term for the role would be Managing Director (MD).

Chief Financial Officer or CFO – This is a term for the director who has responsibility for the financial management and reporting of the company, including the production of financial information such as management accounts and cash flow forecasts, which are required by investors. Another term for the role would be Finance Director.

Class Rights – Specific rights attaching to a class of share (normally the class held by the Investor) providing specific contractual rights with regard to the ongoing management of the business.

Company Secretary – The individual, who has various obligations relating to the duties of the company to file documents at Companies House. A sole director cannot also be company secretary.

Glossary of Common Terms

Copyright – An IP right which arises automatically. It does not protect ideas, only the means by which such ideas are expressed. Copyright may arise in and protect a whole range of works, including publication papers, reports, notebooks, tables, databases, websites, lecture notes, computer programs, source code, operating manuals, charts, diagrams and plans.

Deemed Transfers – A transfer, where typically a member of the management team is required to offer his shares for sale (but fails to do so), as a result of a specified event having occurred (eg ceasing to be employed by the spin-out company).

Designs – IP rights that protect 3D objects or designs applied to them. Design rights arise automatically if the design is not commonplace in the design field in question. Designs can also be registered, if the design is new and has individual character.

Development Capital – Finance typically provided to growing companies who already have a track record, either to expand or to make an acquisition.

Drag Along Rights – Rights available to shareholders holding a specified majority of the equity share capital to require other shareholders to sell their shares at the same time as the majority sell their shares provided the same terms are made available. These are also sometimes known as “come along” rights.

Due Diligence – Detailed analysis and appraisal of the background of the company, its IP, its management and the Business Plan.

Incubation Stage – The part of the process where the spin-out’s principal activities are too large or no longer appropriate for a location in the research institution and have physically moved to dedicated start-up support premises (an Incubator) within the site of or close to the research institution. The term is used by some in a more general way simply to describe the early phases of a spin-out’s life.

Memorandum of Association – This sets out the intention of each of the first shareholders to form a company and to take a share in that company.

Mentor – Someone who acts as a guide and advisor, who can assist you in achieving your objectives with the spin-out, either through their own knowledge and experience and/or through their network of contacts in the business community.

Nominee Director – A director appointed by someone to the board of the company, essentially to be their eyes and ears within the company and (as far as they can) to represent their interests. Your Institution or one of the Investors may want to appoint a nominee director. Whomever appoints them, though, they always have to act in the best interests of the spin-out.

Non-Executive Director – A director who has no role in the day-to-day operation of the company but usually attends board meetings and other meetings and becomes involved in the strategy for the business as and when determined. An Investor will normally appoint at least one non-executive to the board for which they usually receive a fee.

Observer – Someone appointed by a third party, such as your Institution or one of the Investors, to act as the eyes and ears of their appointer. Depending upon the Articles of Association of the company, they may or may not have the right to speak at board meetings. However, as they are not a director, they will not have the right to vote at board meetings

Patents – Registered rights which protect inventions for either products or processes. Details of all UK patents or applications for patents are held with the UK Intellectual Property Office. It is also possible to register patents in Europe and other countries around the world.

Preference Shares – A class of share to be paid which is entitled to a dividend of a fixed amount – in priority to any other dividend. Such shares may also be “redeemable” where the company will effectively buy them back at a fixed price over a period of time.

Proof of Principle (PoP) – This is the activity which takes an idea (frequently expressed in a development proposal format) to a state whereby the idea can be demonstrated in some way such as by a rudimentary prototype, phantom images or sample study, and can generate sufficient data eg statistical evidence, images, computer models, under certain types of conditions, to show that the idea has merit, such that further funding to develop proper working proposals is justified. This will probably be the activity after an invention disclosure has been discussed with the IP commercialisation organisation and before any seed funding proposal is put together. This is regularly called Proof of Concept (PoC), although PoC customarily describes a slightly earlier stage eg just showing basic feasibility. You will however see PoP and PoC used interchangeably.

Ratchet – A mechanism whereby management’s share of the equity is either increased or decreased as a result of performance of the spin-out vehicle. Typically, an upwards ratchet will be applicable where management believe they should have a greater share of the equity on day one and the Investor remains to be convinced but wishes to incentivise the management.

Seed or Seed Corn Funding – This is the money sought to carry out and complete the seed stage activities. The amount can range from modest sums up to approximately £250,000, depending upon the nature of the business idea and its underlying IP.

Seed Stage – The stage at which a business idea is being translated into working proposals. In practice this means the production of a business model and supporting plan, the development of a prototype, the initiation of relevant IP searches and registrations and the initial market research activities to validate the business proposition.

Shareholders' Agreement – This is an agreement entered into by the shareholders of the company to govern their relationship (ie the rights and obligations of each party) and the operation of the company. It may also set out the terms on which each member may be applying (or subscribing) for shares in the company. Shareholders' Agreements may also be referred to as "Investment Agreements" or "Subscription Agreements".

Stakeholders – Those individuals or organisations who are not shareholders but who are likely to be affected by the company's activities and objects, eg banker, loan providers, customers, creditors, debtors, industry and/or social groups.

Statutory Books – This contains a record of the shareholders and directors of the company, directors' interests in the company's shares, charges over the company's assets and minutes of meetings. It may be a book or a looseleaf folder and may comprise one or more of them.

Tag Along Rights – Rights attaching to a minority shareholder requiring the majority to ensure that any offer for the majority shareholding is extended on the same terms to the minority. This prevents a small minority from being left out of an arrangement or deal. These are also sometimes known as "come along" rights.

Trade Marks – Any sign capable of being represented graphically and may consists of words, designs, letters, numerals, colours or even smells or shapes. Trade Marks exist in the UK as both a registered and unregistered IP. Registration offers a cost effective and easier way to protect brand image.

Venture Capitalist or VC – In simple terms, an institution which provides equity or risk capital to businesses with a view to making a large capital return.

Useful Links

British Business Angels Association (www.bbaa.org.uk)

British Venture Capital Association (www.bvca.co.uk)

Companies House (www.companies-house.gov.uk)

Director Bank (www.directorbank.com)

HM Revenue & Customs (www.hmrc.gov.uk)

Institute of Directors (www.iod.com)

Patent Searching (http://gb.espacenet.com)

Spin-out Companies Checklist

WHY CREATE A SPIN-OUT?	**Fundamentals**	■ No existing business in field or platform opportunities ■ Bring together key assets and resources – IP, Management, Money and You ■ Create Business Plan including risk analysis
	Your Role	■ Possibly an initial shareholder or chair of scientific board or similar ■ Possibly a director – but beware of the responsibilities ■ Beware of demands on your time from the spin-out and your employer ■ Seek guidance from a mentor ■ Be ready to adapt to a changing role
IP	**Intellectual Property**	■ Protect the company name through trade marks and domain names ■ Record all IP which the spin-out needs and record who developed it ■ Transfer/license required IP to the spin-out ■ Check IP provisions in spin-out staff contracts ■ Check ongoing arrangements between the institution and the spin-out ■ Identify a person to act as IP Manager ■ Set up a procedure to identify/protect new IP
STRUCTURE	**Shareholders**	■ Shareholders = Owners ■ Owner control is mainly by resolutions ■ Decide on preferential rights to identify types of shares needed ■ Take advice if asked for personal guarantees ■ Take care not to be a “shadow” director
	Shareholders Agreement	■ Regulates shareholders’ arrangements ■ Check which acts need consent of all shareholders ■ Check obligations to provide information ■ Consider limiting liability on warranties

STRUCTURE	**Directors**	■ Responsible for day to day management ■ Observers attend board meetings but can't vote ■ Identify specific roles of executive directors ■ Consider appointing an independent non-executive director ■ Check directors' powers in the Articles ■ Will the Chair have a casting vote? ■ Be aware or directors' duties of independent judgement etc. ■ Act if spin-out is insolvent ■ Think strategically
	Articles of Association	■ Include restrictions public need to know ■ What are limits on your transferring shares ■ Check compulsory transfer provisions on death, leaving spin-out etc. ■ Check drag along/tag along provisions
FUNDING	**Sources/types of funding**	■ Funding may come in cash or in kind ■ Identify suitable sources of funding – possibly business angels or VCs ■ Identify your investor's requirements for warranties, information, control and exit ■ Flag all issues relevant to spin-out's performance to investor ■ Keep spin-outs funding needs under review ■ Understand your shareholding will dilute with new funding
TAX	**Tax**	■ Are shares acquired by reason of employment? ■ Do you benefit from researcher's tax relief? ■ What CGT relief can you get on disposal? ■ Can the spin-out get R&D tax relief? ■ Is the spin-out registered for VAT?
INSURANCE	**Insurance**	■ What insurance does the spin-out have? ■ Is there a key person to insure? ■ Is there D&O insurance to protect directors?