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High growth companies and how to fund them – a real driver of economic growth?

Corporate Acquisitions and Joint Ventures Commission

Prague, 2014 – Working Session 04

National Report of Ireland

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17 April 2014

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The working session in Prague is entitled "*High growth companies and how to fund them – a real driver of economic growth?*" In the working session we plan to address funding alternatives for high growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high growth companies. This questionnaire mainly concentrates on these two topics in relation to high growth companies, but will also cover commercial and regulatory opportunities and constraints.

1. CORPORATE FINANCE – FUNDING ALTERNATIVES

1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

Investors will typically invest by way of equity (ordinary shares and/or preference shares) or loan notes or a combination of both. In recent times investors often seek to invest the majority of funds by way of loan notes particularly where it is difficult to put a valuation on the company while also taking a small percentage of equity.

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

1.2.1 Preference Shares

- The rights attaching to preference shares typically include the following:
  - Liquidation preference – the right to be repaid a guaranteed amount on an exit or liquidation of the company in priority to the holders of ordinary shares;
  - Fixed dividend rights;
  - Right to call for redemption of shares in certain circumstances; and
  - Conversion rights – right to call for shares to be converted to ordinary shares on the occurrence of certain events (e.g. prior to sale of company, listing etc.) at a certain price.
- Capital maintenance rules will apply to the shares which limit the circumstances in which investors can get repayment of amounts invested (see further comments below). In particular, dividends will only be payable to the extent that the company has sufficient distributable reserves.
- The holders of preference shares may also have specific contractual rights such as:
  - Veto rights in relation to certain actions of the company
  - Right to appoint directors
  - Anti-dilution protection

1.2.2 Loan Notes

- The main advantage of loan notes over equity is that it gives greater flexibility in relation to repayment. Capital maintenance rules will not apply to loan notes so it will be easier for an investor to get his/her/its money back together with interest.
- Loan notes may be more suitable where it is difficult to put a valuation on the company in the early stages of its lifecycle and will guarantee a repayment of a fixed amount.
- Convertible loan notes give an investor an opportunity to convert their loans into equity at a later date or on the occurrence of certain events (e.g. listing. trade sale etc.).
- Loan Note holders can also avail of specific contractual rights as mentioned in clause 1.2.1.

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

- Capital maintenance rules - It is a fundamental principle of Irish company law that the share capital of a private limited company should be maintained for the life of the company so that a company's creditors can rely on the existence of such share capital in a winding up situation. For that reason the Irish Companies Acts 1963 – 2013 (the "**Companies Acts**") contains a number of prohibitions on a company reducing its share capital. This will be particularly relevant when a company proposes to (i) redeem shares held by a shareholder; (ii) purchase its own shares; (iii) carry out a reduction of share capital; or (iv) make a distribution/pay a dividend to its shareholders. In order to make a distribution and prior to carrying out a redemption/share buy-back, a company must have sufficient distributable reserves to do so.
- Central Bank consent – Where a company is regulated or licensed by the Central Bank of Ireland ("**CBI**"), the consent of and/or notification to the CBI may be required where there is a change in direct and/or indirect shareholding following such investment.
- Other regulatory constraints may apply depending on the investee company's industry.

1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

- Crowdfunding is a funding alternative in Ireland. While the development of the crowdfunding is still at an early stage, it is predicted the market for such

lending to small businesses in Ireland could grow to €100 million in three years[1].

- There are currently just four Irish-based crowd-funding platforms.
- The benefit of crowdfunding is that it gives small-start-ups access to cash which they may not otherwise have access to from commercial banks or Venture Capital Funds.
- From the perspective of the entrepreneur, they will have limited risk while companies themselves can avoid having to obtain high interest loans at early stages of their development.
- One downside of crowdfunding is that the amount of cash available can be limited.
- There is currently no legislation or regulations in Ireland dealing with crowdfunding but operators of crowdfunding platforms need to be careful that any such offerings do not fall within regulated services such as "investment services" (within the definition of the Markets in Financial Instruments Directive 2004/39/EC) or "banking business" (under the Central Bank Act 1971).

2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e. founders-family-friends, angel investments, venture capital investments, private equity)

- The types of investors in a high growth company will typically depend on the stage that the company is at in its life cycle.
- At earlier stages of development, investment will typically be confined to founders-family-friends.
- External investors at early stages are mainly business angels who will invest amounts upwards of €25,000 and often take a more active role in the company.

[1] http://www.irishtimes.com/business/sectors/financial-services/peer-to-business-lending-could -be-100m-market-by-2017-1.1662308

- There are a number of active Seed Capital Funds currently in the Irish market investing typically around €250,000 - €500,000 in early stage companies.
- Venture Capital Funds typically enter at Start-up Stage and follow on into Expansion and Development stages investing in larger amounts.
- There are a number of Development Capital Funds that have recently been established in Ireland for the purpose of investing development and growth capital in established, mid-sized and profitable company to support and accelerate growth.

2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?

- The size of the investment will largely depend on the type of investor, the industry and the stage that the company is at in its lifecycle. Some investors will require matched funding of the amount being invested as a pre-condition to completion.
- Business Angels will typically invest between €25,000 to €250,000.
- Seed Capital Funds will typically invest amounts up to €500,000 while Venture Capital Funds and Development Funds will invest between €500,000 to €20,000,000.

2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)

- The usual documents that will be entered into/adopted on completion will be:
  - Subscription and Shareholders' Agreement/Investment Agreement
  - Disclosure Letter
  - Loan Note Instrument
  - Articles of Association
  - Service Agreements – Founders
  - Put Option Agreement

- **Subscription and shareholders' agreement/Investment Agreement** – this will typically deal with the following:
  - Terms of the investment
  - Warranties

- Restrictive covenants
- Veto rights of investors
- Composition of the board – right to appoint directors
- Information rights
- Transfer of shares
- Issue of new shares
- Dividend policy
- Dispute resolutions
- Drag/tag along rights

- **Disclosure Letter** – qualifies the warranties contained in the subscription and shareholders' agreement/investment agreement.
- **Articles of association** – if a company does not file its articles of association at the Companies Registration Office, then the model form articles contained in Part II of Table A of the First Schedule to the Companies Act 1963 will constitute the articles of association of the company. In practice however, it would be more usual for a company to adopt a set of articles which deal with**:**
  - the rights attaching to each class of share;
  - voting rights;
  - rights of pre-emption on new allotments/transfers (if any);
  - compulsory transfers (e.g. on bankruptcy, death, default, insanity, ceasing to be an employee etc.);
  - proceedings at meetings (directors and shareholders).
- **Loan Note Instrument** – the loan note instrument will typically will set out the rights attaching to the loan notes (interest, repayment, conversion etc.). It may also include provisions relating to proceeds at meetings of the Noteholders.
- Investors may also require that the Company enters into a **put option agreement** whereby they can require that that company purchases the shares held by such investors on the occurrence of certain events.
- The Founders may be required to enter into **service agreements** with the company on completion of the investment.

2.4 Are there incentive schemes for investing into high growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?

The Irish Government provides a range of supports as set out below:

- Under the Seed & Venture Capital Scheme (2013 – 2018) the Irish Government through Enterprise Ireland (the Irish development agency for Irish companies in world markets) committed to invest €175 million in Venture Capital Funds to stimulate job creation and support young innovative Irish companies;

- Enterprise Ireland also invests directly in early stage and developing companies and offers grant aid to companies established in the State subject to certain conditions (discussed further below);

- In June 2012, the National Pension Reserve Fund ("**NPRF**") announced collaboration with Silicon Valley Bank, which will make $100 million in lending available to fast-growing Irish technology, life science, cleantech, private equity and venture capital companies;

- The NPRF is also developing a SME Equity fund to support private equity investment in Ireland;

- Microfinance Ireland ("**MFI**") has been set up to deliver the Government's Microenterprise Loan Fund. MFI's objective is to provide lending to start-up and early stage companies which do not meet the conventional risk criteria applied by commercial banks;

- The Employment and Investment Incentive Scheme was introduced by the Finance Act 2011 and is aimed at encouraging investment by private individuals in small and medium enterprises. It offers relief by way of a deduction against income tax for "qualifying individuals" for amounts subscribed for "eligible shares" in "qualifying companies".

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

- As stated at 1.2 an advantage of loan notes over preference shares is greater repayment flexibility irrespective of whether the investor is international or

domestic. The interest accruing on loan notes can be paid to the Noteholder in circumstances where a fixed dividend on preference shares might not be able to be paid due to a lack of distributable profits. Similarly, a loan note can be repaid where the redemption of preference shares may not be permitted by the Companies Acts.

- Loan notes may also be preferable to an investor for certainty of repayment amount where it difficult to place a defined valuation on the company at the date of investment.
- Convertible loan notes offer investors an opportunity to take equity in the company at a later point.

3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

3.1 Which company form is most popular? (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)

- The usual company form for high growth companies is the private company limited by shares.
- A private company limited by shares must have:
  - at least one shareholder;
  - at least two directors, who must be natural persons; and
  - provisions in its articles of association:
    - restricting the right to transfer shares in the company;
    - limiting the number of its shareholders to 99 plus present and past employees; and
    - prohibiting any invitation or offer to the public to subscriber for securities of the company.
- The liability of each shareholder will be limited to the amount subscribed for the shares held (nominal amount of each share together with any premium paid).
- Division of responsibility between directors and members:
  - directors are responsible for the day-to-day management of the company and can exercise most company powers (e.g. issue of new shares, borrowing powers, use of company seal, declaration of dividends) subject to any restrictions set out in the articles of association or a shareholders' agreement/investment agreement;

- the requirement for member approval is driven by the Companies Acts or a company's articles of association/shareholders' agreement/investment agreement (e.g. approval of accounts, changes to the memorandum and articles of association etc.). As most matters of importance are delegated to directors, the shareholders typically will not intervene unless their approval is required for a particular transaction or act.

- Unlike civil law jurisdictions, Irish law provides for only one board of directors, rather than a two-tier system. It is therefore a matter for the board of directors to organise the governance of the company in a manner which best suits the company.

3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?

Software, internet, games and media and life sciences.

3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies (e.g. accelerators/incubators? Other?)

- Ireland currently has approximately 27 accelerators/incubators which have been set up with the aim of nurturing and supporting start-ups and early stage companies. Some accelerators offer mentoring, legal and tax advice as well as access to funding sources while others offer micro seed investments for a small equity stake.

- Enterprise Ireland in particular offers an number of supports to companies such as:

  - Competitive Start Fund – Enterprise Ireland offers up to €50,000 to early stage companies for a 10% equity stake subject to an investment of €5,000 by promoters.
  - The High Potential Start Up ("**HPSU**") Fund is a fund which supports start-up and development costs of HPSU companies. Enterprise Ireland will offer an equity investment typically on a co-funded basis. The level of investment will be determined on a number of factors including growth potential.
  - International Start-Up Fund – under this fund, investment is available for overseas entrepreneurs locating their start-up businesses in Ireland.
  - HPSU Feasibility Grant – a grant up to a maximum amount of €50,000 to assess the viability of new export orientated.

- R&D Fund – this fund supports products, processes or service R&D projects where expenditure is less than €150,000.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

For small family run companies, the entrepreneur may wish to buy the investor out within a certain defined period and on that basis a loan note instrument may be preferable. The entrepreneur will retain control of the company and will not have to part with equity.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

- The level of control that an investor will take will depend on the individual/fund and his/her/its investment strategy as well as the stage that the company is at in its lifecycle at the time of investment. At earlier stages, where the investment is largely from family and friends, the investors will often take a passive role and let the entrepreneur have full control of the business. However as it moves towards the seed stage and takes in angel investment, the investor may wish to take more active role in the company and in particular may seek to take a seat on the board. Seed and Venture Capital Funds will typically seek a right to appoint directors/observers on the board and have certain veto rights but day-to-day involvement in running the company may be limited.

a. Anti-dilution measures

Seed Capital and Venture Capital Funds will typically seek some type of anti-dilution protection. This may be in the form of a specific anti-dilution clause or simply the right to participate in future rounds of funding.

b. Rights of first refusal, pre-emption rights, drag and tag along

- Transfer of shares - except for transfers to permitted transferees (such as close family members or controlled companies), investors will typically limit the scope of founders and management shareholders to transfer their shares.
- Pre-emption rights on transfer/allotment of shares - the articles of association generally contain pre-emption rights preventing shareholders (subject to certain exceptions) from transferring their shares to third parties, unless they have first offered those shares to existing shareholders on the same terms. Similarly on the allotment of new shares, investors will generally seek a right of first refusal for all new issues of shares.
- Tag-along – typically the articles of association and/or shareholders' agreement/investment agreement will contain tag along provisions to protect a minority in the event that the majority/founders seek to sell shares without invoking drag along rights. In the event of an offer for their shares from a third party purchaser, the majority shareholders/founders must procure that the third party acquires the rights of the minority shareholders/investors on the same terms.
- Drag-along – the articles of association and/or shareholders' agreement/investment agreement may contain drag along provisions to compel minority shareholders to join a sale of all shares in the company where such sale is desirable to a certain percentage of the total shareholders. Under Section 204 of the Companies Act 1963, there is a statutory procedure which allows an 80% majority to require the dissenting minority to sell their shares. The majority required enforcing the drag along provisions in the articles of association and/or shareholders' agreement/investment agreement can be set at any level which his commercially agreed.

c. Protective provisions

As discussed above, investors typically seek a number of contractual protections in the subscription and shareholders' agreement/investment agreement as follows:

- Warranties;
- Liquidation preference;
- Anti-dilution;
- Veto rights in respect of certain acts of the company.

d. Information rights

Investors typically seek access to management accounts, audited accounts and other financial information at regular intervals particularly where they do not have the right to appoint a director or chose not to enforce such right. They may also seek the right to access the company premises and to speak to staff.

e. Dead-lock resolution

- Shareholders' agreements/investment agreements may include dispute resolution provisions such as mediation, arbitration or referral to an expert.
- The shareholders' agreement/investment agreement may include deadlock provisions where the parties cannot come to a resolution. Where there is a complete breakdown in the shareholder relationship over a fundamental issue, the usual way to resolve the deadlock is for one shareholder to exit. Deadlock provisions will typically define what will constitute the deadlock (e.g. where matters are subject to veto rights or where resolutions cannot be approved). Sample clauses are as follows (these are generally only suitable where there are 2 shareholders in a 50:50 scenario):
    - Russian roulette clause – this type of clause provides that one shareholder may serve notice on the other offering to transfer all of his/her/its shares in the company to the other shareholder at a specified price. The other shareholder must buy all of the shares so offered at that price or sell all of his/her/its shares at the same price per share.
    - Texas/Mexican shoot out clause – this is a variation of the Russian roulette clause and typically provides that one shareholder may serve a purchase notice on the other offering to buy the other out at a particular price. The other shareholder has an opportunity to issue a counter notice either agreeing to sell at the price set out in the offer notice or offering to buy the shares of the other party at a higher price.
- Another option may be to give the chairman a casting vote. This may not always be an appropriate solution particularly where the chairman in not independent of the shareholders.

f. Board seats / observer rights

An investor will not have an automatic right to appoint a director although it is normal for a shareholders' agreement/investment agreement to include provisions giving investors the right to appoint directors to the board which may be dependent on holding a minimum % shareholding. An investor may also have the right to appoint a non-voting observer to attend board meetings.

g. Any other terms specific/important in your jurisdiction?

- Other key points for consideration:
  - Good leaver/bad leaver protections applying to the equity and/or options held by founders.
  - Restrictive covenants and confidentiality provisions.

5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

- The most common forms of exit are a trade sale, management buyout, a listing or, where the company has been unsuccessful, liquidation.
- Investors will often seek an entitlement after a certain period of time (around five years typically) to appoint a corporate finance adviser to instigate a process that will lead to a trade sale or listing.

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?

- This will depend on the type of investor, level of investment being made and the relative negotiating power he/she/it has.
- For smaller investment rounds, new investors may simply be required to enter into deeds of adherence to an existing shareholders' agreement/investment agreement. For larger funding rounds and particularly where the investor is taking sizeable shareholding in the company, a new investment agreement may be negotiated which will supersede all existing agreements. This may

incorporate the exit strategy of the new investor or give the new investor certain veto/consent rights to existing provisions around exit.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?

Irish Tax Rates

The rate of corporation tax a company will pay in Ireland depends on the nature of the income earned. The applicable tax rates are set out below:

- Trading Income 12.5%
- Passive Income 25%
- Capital Gains 33%

There are a number of tax advantages for start-up companies and high growth companies in Ireland including start-up company relief (where companies commencing trading before the end of 2014 can benefit from an exemption from corporation tax and capital gains tax on the disposal of assets used for the new trade), tax credits for expenditure on research and development, employment and investment incentive relief etc.

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.

As above.

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).

As above.