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

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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.?

Traditionally, the typical way of financing a company in Uruguay has been to obtain financing from local or foreign financial institutions. However, over the last years, due to the growth in the economy, the professionalization of the market, globalization and the enactment of new laws and regulations on the securities market, we have experienced a variation on this trend. Companies which used to be closely held have started to open up and let in outside investors through the use of financial instruments. It is expected that this tendency will continue to develop over the next years.

The financial instruments which are more typically used when investing in all types of companies in Uruguay are equity instruments, typically ordinary and preferred shares.

Negotiable debt securities have been also used for certain investments but they are not as common as equity instruments. As a result of the economic crisis in Uruguay in the years 2002 and 2008 (which caused certain issuers to default) and the inadequate regulations that existed at that time regarding negotiable debt instruments, investors lost confidence in this instrument and consequently few issuances of negotiable debt instruments have been made in the last years. In 2009, material changes were made to the existing regulations on negotiable debt instruments which included the creation of tax benefits for issuers. Although these changes were positive for the development of negotiable debt instruments, they also increased the associated costs, so they have not been enough to activate the negotiable debt instruments market among high growth companies.

Other financial instruments which are typically used for project finance are certificates of participation in financial trusts. Trusts are basically a way to apply assets (money, credits, personal and real property) to a certain transaction and protect them from various risks as the assets delivered to the trust cease to be the property of a particular person. In financial trusts, the beneficiaries hold trust participation certificates, debt securities guaranteed by trust assets, or mixed instruments granting credit rights and participation rights to the remainder. Although the use of financial trusts has been quite spread over the last years, they are not used as a way to finance a company itself, but a particular project.

Almost all issuances of shares, negotiable debt securities and certificates of financial trusts are made through private offerings in Uruguay. The volume of transactions in the public market in Uruguay has been relatively small; the local financial public market for shares has been practically non-existent. Only a few companies quote their shares in the Montevideo Stock Exchange and with minimal transactions during the year.

The use of convertible debt, warrants, stock options or hybrid instruments is not common in Uruguay.

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.)

Shares (ordinary and preferred): The pros of using shares as the financial instrument for investment in Uruguay are basically the same as in other jurisdictions: it allows the investor to gain control in the company and to participate in the revenues. From the point of view of the company, the cost of being financed with equity is lower than the cost of being financed with debt. The cons are also similar to other jurisdictions: the shareholders´ claims in case of liquidation will be subordinated to the creditors' claims and during the life of the company shareholders will only receive distributions in case there are revenues to distribute.

It is also worth noting that shares can only be issued in corporations; in the rest of business entities the capital cannot be represented by shares, it has to be represented by membership or partnership interests which are non-negotiable instruments.

Negotiable debt securities: Negotiable debt securities can be issued by all local or foreign companies in Uruguay and there are no limits as to the amount of the debt that can be issued by each individual issuer. Other pros are: creditor´s claims against the assets of the company are prior to the shareholders claims; negotiable debt securities can be issued with collateral in order to guarantee payment and, absent insolvency, the owners of negotiable debt instruments will receive their payments regardless of the revenues that the company has. On the other hand, negotiable debt instruments do not grant control over the company (except that under certain circumstances their owners have inherence in certain corporate decisions), and owners of negotiable debt instruments will always receive a fixed income regardless of the revenue that the issuer has.

Certificates of participation in financial trusts: From the company´s point of view, the assets which are affected to the trust are withdrawn from the company´s net worth so the risk of the investment is limited to the assets contributed to the trust. And from the investor´s perspective, the assets contributed to the trust are protected from the company´s other creditors. As a downside, the company loses control over the assets contributed to the trust as the administration is carried out by the trustee.

It is worth noting that in private offerings, shares and negotiable debt instruments can be issued as bearer, nominative or book-entry securities while in public offerings shares and negotiable debt securities have to necessarily be issued as book-entry securities. If the offering is public, securities must be issued as electronically registered instruments; the issuer must register them in the Registry of Book-Entry Securities that must be carried out by a registering entity and they can only be transferred by a registration in the electronic account in the Registry of Book-Entry Securities.

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

With regards to equity instruments, the current legislation in Uruguay relating to the rights and limitations that can be granted to preferred shares is quite restrictive as Law 16,060 (hereinafter the "Corporations Act") enumerates them exhaustively. Given that most scholars and the Corporate Oversight Authority (governmental entity which has oversight in corporations) understand the article of the Corporations Act which refers to preferred shares cannot be altered by agreement of the parties, shareholders are not allowed (not even by unanimity) to grant any right or limitation to preferred shares different to the ones provided in the Corporations Act. Consequently, corporations and shareholders are deprived of the possibility of structuring the share capital in the way they deem more convenient, which limits flexibility and creativity in the use of preferred shares. This has presented a disincentive for their use. However, this obstacle has been traditionally solved by the use of shareholders agreements where the shareholders can agree on the rights and limitations that they want each one to have.

With regards to negotiable debt securities, the fact that the Board of Directors cannot resolve its issuance by itself - without authorization in the bylaws or granted by the shareholders - can be considered a constraint for the development of the instrument. According to the Corporations Act, in corporations the issuance of negotiable debt securities must be provided in the bylaws of the company or must be resolved at the extraordinary meeting by shareholders representing the majority of paid-in capital.

Other regulatory constraints are related to the nature of the offering (public vs. private) and not to the type of security. In case of public offerings of equity or debt, the issuers and the security have to be registered and the requirements for registration are burdensome, onerous and time-consuming. This creates an obstacle for certain companies to resort to public offerings as a financing alternative.

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

Crowdfunding - as a way of funding a company or project by raising small amounts of money from each investor usually through general solicitation via

Internet platforms – although it is theoretically a funding alternative in Uruguay it is not used in practice.

One of the reasons for this is that in Uruguay – according to Law 18,627, its modifications and regulations-, public offerings must be registered, together with the issuer, at the Security Markets Registry of the Superintendency of Financial Services of the Uruguayan Central Bank.

And, according to article 1 of the Compilation of Rules relating to the Securities Market of the Uruguayan Central Bank[1], there is a public offering when: 1) the offering is directed to the general public or to certain sectors or specific groups which are undetermined at the moment of making the offering; 2) the offering is made with the participation or through a stock exchange; 3) the offering is made public through any means; 4) in case of financial trusts created by an unilateral act; and 5) the offering is made by a company that is already registered in the Securities Market Registry.

This means that crowdfunding - with the concept previously mentioned – would be considered a public offering in Uruguay and as such the issuer and the securities would have to be registered. In order to obtain registration, the issuer must file certain information and documentation about itself (such as bylaws, viability studies, audited financial statements, among others) and about the securities (prospectus project which must contain among others: description of the investment project or destiny of the colocation, indication of plan for the use of proceedings, projected cash flows, risk assessment reports made by an accredited and registered entity). In addition to the aforementioned requirements for inscription, it is worth noting that registered issuers must comply with ongoing reporting requirements.

Given that the requirements for registration of the issuer and securities are burdensome, onerous and time-consuming, crowdfunding is not used in practice.

Finally, it is worth mentioning that article 4 of Law 18,327 sets forth that the Superintendency of Financial Services of the Uruguayan Central Bank can establish differential requirements for registration due to the type of security, of offering, of the investor or of the issuer. Therefore, it would be legally possible for this entity to set differential registration requirements for crowdfunding.

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

[1] Available at http://www.bcu.gub.uy/Acerca-de-BCU/Normativa/Documents/Recopilacion-de-Normas/Mercado%20de%20Valores/libro01.pdf

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)

Traditionally, the typical investors into high growth companies in Uruguay have been founders, family and friends in the case of local companies and the headquarters in the case of international companies. However, in the last years, we have experienced an increase of investments of private equity firms. Also, venture capital investors and angel investors have had some presence in private equity transactions, although their participation is less frequent.

Almost all private equity investors which have invested in Uruguayan companies in the last years are foreign funds, mostly from the United States, Europe and Latin America. Uruguay has managed to attract these private equity funds due to its economic growth over the last years, its political and legal stability and because of the economic crisis in Europe and United States.

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

No, there is not. The size of the investment usually depends on the amount that the private equity fund is able and is willing to invest and on the size of the company it is investing in.

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.)

Typically, the process starts with the execution of a non-binding Memorandum of Understanding or Letter of Intent where the basic terms and conditions for the transaction and for the due diligence process are set. The execution of this document is also usually accompanied by a non-disclosure agreement whereby the parties agree to keep all the information that is disclosed during the negotiations confidential.

After the due diligence process is completed, the parties usually execute a Share Purchase Agreement or a Contribution Agreement through which the investment is acquired.

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.)?

Uruguay has had an effective Investment Promotion Regime since the year 2007 through which the Executive Branch chooses to promote certain investment projects or sectors that comply with the eligibility criteria set forth in the law. The chosen projects are granted significant tax benefits. Since the year 2009, investment in Uruguay – especially foreign investment – has been consistently growing.

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?

The preferred instrument in Uruguay from the point of view of an investor is equity because the investor can gain at least a certain level of control in the company`s affairs and because the returns of the investment are potentially higher than investing through debt instruments. This does not change if the investor is international or domestic as both categories are treated equally.

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 majority of business entities operating in Uruguay are organized either as corporations ("*sociedades anónimas*" or "*S.A.´s*") or foreign company branches. However, some companies choose to operate as limited liability companies ("*sociedades de responsabilidad limitada*" or "*S.R.L.´s*") or partnerships limited by shares ("*sociedades en comandita por acciones*" or "*S.C.A.´s*") mainly because of the tax regime in United States under which S.A.´s are mandatorily taxed as corporations while other type of business entities can chose by "*checking the box*" to be taxed as corporations or as pass-through entities.

There are no restrictions with respect to citizenship, residence or domicile of partners, shareholders and directors of companies in Uruguay, except for certain specific activities that are considered to be in the national interest (such as aviation, international road and maritime transport of goods and/or passengers, broadcasting of radio and TV).

From a liability point of view, in a S.A. shareholders are, in principle, only liable up to the amount of shares subscribed. In S.R.L.´s members are liable in principle only for the amount of subscribed membership interests. However, some particularities should be considered, which make member's liability in S.R.L.´s more severe that the shareholders in corporations: (a) according to tax regulations, when members of an S.R.L. act as managers they are jointly and severally liable for income tax applicable to the company; and (b) S.R.L.´s members are jointly and severally liable for salaries unpaid by the company plus legally applicable interest. Lastly, in S.C.A´s, there are two types of members: active members who are unlimitedly, subsidiary and joint and several liable for all the company´s obligations and limited partners who are only liable to the amount of shares subscribed.

With regards to the tiers of management, the governance of the entity rests with the Board of Directors which can grant powers of attorney to officers to act on the company´s behalf. However, the Board of Directors remains responsible for the acts of the officers.

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

The sectors which are most preferred by high growth companies are agro-industrial, agribusiness, information technology and renewable energies.

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

Yes, there are several governmental and private accelerators and incubators which incentivize high growth companies, particularly companies founded by entrepreneurs who have innovative ideas.

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

Entrepreneurs usually require investments in the form of equity as they do not have assets to operate as a guarantee for a loan and they do not have fixed income for repaying the loan at the beginning. Therefore, it is usually more convenient for them to give the investor equity in their business and have the investor run the same risks and participate in the earnings of the endeavour.

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:

a. Anti-dilution measures

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

c. Protective provisions

d. Information rights

e. Dead-lock resolution

f. Board seats / observer rights

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

The control that a typical investor takes over a high growth company depends greatly on the type of investor. Venture capital funds or angel investors typically take a minority stake in the company and leave the existing management to manage the company, always keeping veto power over certain material decisions. On the other hand, private equity funds typically take control of the company, acquiring all or a majority portion of the company and leave the existing management to carry out the company´s business as employees.

With regards to the specific terms mentioned:

a. Under Uruguayan Corporate Law, shareholders always have pre-emption rights in the case of a paid-in capital increase so the law already sets forth an effective anti-dilution measure. In practice, the new investor usually agrees on a business plan with the existing shareholder/s which sets forth the contributions that each one is going to make over the following years so the parties already know beforehand if their participation is going to be diluted and the funds it has to contribute in order to prevent dilution.

b. It is typical for investors to subscribe shareholder agreements with the exiting shareholder/s which usually contain provisions governing the transfer of shares among shareholders and to third parties. These provisions commonly include the right of first refusal and drag and tag along rights. In order to enforce these provisions and to guarantee compliance with the shareholders agreement, it is typical that the shareholders reciprocally pledge their shares in the company.

c. Protective provisions such as veto rights over certain material decisions are typically included in shareholder agreements. They are more common among venture capital funds or angel investors where investors do not acquire control of the company but they still want to have the right to block certain decisions. In private equity transactions, it is also common to include that certain significant resolutions need to be adopted unanimously by the shareholders meeting. The natural consequence of such provision is that every shareholder has veto rights over certain decisions.

d. Uruguayan Corporate Law grants the right to all shareholders to obtain certain information from the company. However, this information is generally insufficient to investors so the shareholder information rights are usually agreed upon at the shareholders agreement and business plan before the investment is made.

e. Dead-lock resolution methods are almost always included in shareholder agreements when the investment is structured in a way in which there is potential for a dead-lock situation to occur. The most commonly used methods are call and put options with a pre-determined process to fix the price of the option. In order to guarantee compliance with these provisions, the shares are usually reciprocally pledged by the shareholders.

f. Investors typically require Board seats, even if they come into the company with a minority stake as being in the Board gives them an oversight on the company matters, even if they vote is not decisive. Observer rights are quite uncommon.

g. In Uruguay, the relationship between the investor and the existing shareholder/s is generally governed by a shareholders agreement which is usually signed together with a share pledge agreement and a share deposit agreement with an independent third party who acts as depositary. In order to be enforceable against the company and third parties, shareholder agreements need to be signed with notarized signatures, a copy of the executed agreement must be delivered to the company, they must be registered with the National Registry of Commerce and its existence must be registered in the share certificates and in the book of nominative or book-entry shares.

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 type of exit is the sale of equity to a third party (which can be a private equity fund) or to the previous company shareholders. Due to the size of the Uruguayan stock market, to its slow development and to the high costs associated, an IPO in the Uruguayan stock market is not used as an exit strategy. However, it is quite common to include in the shareholders' agreement the possibility of making an IPO in another jurisdiction of the shares of the Uruguayan company or of the foreign holding company of the Uruguayan entity as an exit strategy.

The typical transaction length depends on the type of investor.

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?

In the case of new investors, there are usually tag along or drag along rights involved so that the new investor is obligated to acquire all of the equity of the target company or the same percentage of equity from each shareholder. Most shareholder agreements include provisions setting forth that in the case of a sale of equity, the seller is obliged to ensure that the new shareholder agrees to be bound by the shareholder agreement. However, when a new investor comes in, depending on its leverage, it is common that it requests amendments to the existing shareholder agreement or that a new shareholder agreement is entered into.

6. REGULATORY ISSUES

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

High growth companies can apply to be eligible for tax benefits under the Investment Promotion Regime. This regime allows the Executive Branch to promote certain investment projects or sectors that comply with the eligibility criteria set forth in the law. It is worth noting that in the year 2013 there was a record on the amount of the projects that were promoted by the Executive Branch, reaching the total sum of US$ 2,931 million.

It is also common for certain high growth companies which operate abroad to establish in free trade zones (FTZ). These are duly enclosed and isolated public or private areas within national territory where FTZ companies are allowed to undertake all types of industrial, commercial and service activities with tax exemptions and other benefits. FTZ regime was adopted with the purpose of encouraging investments, expanding exports, increasing use of Uruguayan labor and fostering international economic integration.

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.

With regards to the incentives, Uruguay law grants foreign investors the same treatment than to Uruguayan investors. The free transfer of capital and profits is guaranteed, and no exchange control is applied on the flow of national and foreign currency.

Regarding the obligation for local participation, there are few actual restrictions on investors in certain sectors: (i) Aviation: only individuals and companies domiciled in Uruguay and companies incorporated in Uruguay and with registered shares will be granted Uruguayan flag registration of an aircraft with the State Office. (ii) International road and maritime transport of goods and/or passengers: More than 50 % of capital stock of the Uruguayan company must be held by Uruguayan citizens domiciled in the country and control of the company must be entrusted to citizens domiciled in Uruguay. (iii) Media and Telecom: Broadcasters (Radio transmitters and open TV services) must have registered shares and shareholders must be Uruguayan citizens domiciled in the country.

In relation to the ownership of rural land for agribusiness purposes, only individuals or certain companies, which shareholders could be clearly identified, can be owners of land in Uruguay. There are no restrictions on foreigners' ownership of land if they comply with the above mentioned requirement.

There is no co-investment obligation.

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).

Under Uruguayan law, there is no restriction for choice of law and competent jurisdiction if an arbitration clause is agreed. Therefore, if an international arbitration provision is included, the parties are free to choose the applicable law to the contract and the award rendered will not be vacated or denied recognition in Uruguay on the grounds that the arbitrators applied an improper law. Foreign judgments and arbitral awards are enforceable in Uruguay in accordance with the provisions of the General Code of Procedures.