Spin-off GUIDE

Knowledge Circle

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Contents

Why create a spin-off company? ... 3
Documentation ... 6
Shareholders and Directors ... 7
Role of the Shareholder ... 7
Powers of the Shareholders ... 8
Payment of Dividends ... 8
Role of a Director ... 8
Shadow Director ... 9
Executive and Non-Executive Directors ... 9
Directors' Powers ... 10
Directors' Duties ... 10
Wrongful Trading ... 12
Penalties ... 12
Funding ... 13
1. Research Institution ... 14
2. Business Angels ... 14
3. Venture Capitalists ... 14
Dealing with investors ... 15
The next stage ... 16
Reduction in Original Shareholding (Dilution) ... 18
Company documentation ... 20
Shareholders' Agreement ... 21
Articles of Association ("*Contrato Social*" in Portuguese) ... 24
Permitted transfers ... 24
Compulsory transfers ... 25
General transfer mechanism ... 26
Exit arrangements ... 26
Tax Issues ... 27
Income Tax on the Acquisition of Shares ... 27
Future Charges to Income Tax ... 27
Share Options ... 28
Tax and the Company ... 29

References 31

Why create a spin-off company?

Start-ups that emerge from research institutions are more likely to be successful than those that do not have such origins. This happens because research institutions provide a **strong foundation** for start-ups by offering a supportive environment for **innovation**, access to **cutting-edge research**, and **funding opportunities** (WIPO, 2022).

Moreover, research institutions often have access to a vast network of experts and collaborators, including scientists, engineers, and business professionals, which can provide start-ups with valuable insights and support. This access to resources can be crucial in developing and commercializing new technologies (University of Manchester Innovation Factory, n.d.).

There are several ways to monetize intellectual property, such as selling it outright or licensing it. However, creating a spin-off company may offer certain advantages, such as distancing the IP from the research environment. This can be particularly important if the research institution has limited resources for commercialization, or if the research environment is not conducive to entrepreneurship. To make a spin-off company successful, it will require a **combination of resources and assets**, including funding, specialized management, and facilities like labs or manufacturing plants. Some spin-off business models may also choose to outsource manufacturing and distribution while licensing their IP (University of Manchester Innovation Factory, n.d.; WIPO, n.d.).

To create a successful spin-off company, you can either or not have intellectual property rights, but it will be valuable to have **protected intellectual property (IP)**, which forms a basis of a sustainable business opportunity. It's important to conduct market research early to ensure that the ideas protected by the IP can generate a return for investors. According to the European Union Intellectual Property Office, conducting a Freedom to Operate (FTO) analysis early in the technology transfer process can help identify potential patent infringement risks and provide valuable insights into the competitive landscape (EUIPO, 2023).

Investors expect the spin-off company to be led by a **management team** with proven skills in areas such as **finance, marketing, and sales**. It may require the original

IP creator to take a back seat in the management of the company as new people become involved. It is important to have a **strong management team** with the necessary skills and experience to take the company forward. As noted by the European Association of Technology Transfer and Innovation, "the creation of a spin-off company requires a unique combination of entrepreneurial talent, business acumen, and scientific expertise" (European Association of Technology Transfer and Innovation, 2023).

The spin-off company will need **funding** to develop and grow, which can come from various sources such as venture capitalists or family and friends. However, as highlighted by the European Investment Fund, "it's important to choose the right type of funding that matches the stage and needs of the company" (European Comission, 2023). A **Business Plan** is essential when seeking funding, and the IP originator is vital to the transfer of IP to the company and ongoing development and support to the company's managers (University of Manchester Innovation Factory, n.d.).

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.

Source: (University of Manchester Innovation Factory, n.d.)

Documentation

There are essential papers and considerations that will probably have significance while establishing the spin-off (University of Manchester Innovation Factory, n.d.).

- **Business plan.** ”The business proposition's strategy and operational plans should be condensed into a clear and concise outline that effectively communicates the business opportunity. While the plan's specifics may change frequently based on input from others and the business's development, it is crucial to establish a clear understanding of the fundamental business model and market approach (i.e., identifying the target customers and how to approach them). The entire board of directors must take responsibility for ensuring the plan is a credible and robust strategic document”.
- **Heads of terms.** ”These points summarize the main agreements of a deal or arrangement. They serve to ensure that all parties understand the deal and serve as a record of the initial agreement discussions. It is essential to draft them in a manner that is not legally binding, except in regard to confidentiality. These points are intended to be a non-binding understanding of the agreement until formal legal documentation is prepared”.
- **IP Assignment/Licence.** ”It is necessary to establish whether the company owns or has the right to use IP, assets, or equipment required to conduct its business. If so, the terms of such agreements should be documented”.
- **Employment Agreements.** ”As a researcher, it is essential to determine whether you will be an employee, consultant, or seconded to the company on a full-time or part-time basis. Additionally, the company's need for other employees must be evaluated, and it must be ensured that there are sufficient funds to pay salaries. The terms of such agreements should be recorded in writing for future reference”.

- **Facilities Agreements.** ”It is crucial to determine whether the company will require access to office and laboratory space. Institutions can offer additional services, including bookkeeping and accounting during the spin-off's initial stages, as well as access to incubator facilities. In addition to providing office and laboratory space, institutions may also provide other vital services to the spin-off”.

Obtaining guidance from independent legal and accounting experts is essential when dealing with these matters, as they are intricate and necessitate a high level of expertise to ensure proper legal and ethical conduct. Seeking professional advice can assist in avoiding expensive mistakes and guaranteeing that all legal and financial responsibilities are fulfilled.

Shareholders and Directors

You may find yourself in a situation where you hold both a director and shareholder position within the company. This can present a complicated scenario that demands careful thought concerning the privileges and obligations associated with each role.

Role of the Shareholder

As a shareholder, you may be required to provide **personal guarantees** for loans or other liabilities incurred by the company. In such cases, your personal assets could be at risk in the event of default or non-payment by the company. It is advisable to seek **professional advice** before providing any such guarantees, as they could have significant financial implications (GOV.UK., 2021).

As a shareholder in a private limited company, your liability is limited to the amount, if any, which remains unpaid on your shares. You may, for example, be required by lenders to personally guarantee any borrowings by the company. If you are asked to do this by a funder or supplier or any other third party, you should, be extremely wary and take professional advice. (University of Manchester Innovation Factory, n.d.).

Powers of the Shareholders

Shareholders' powers are effectively exercised by the shareholders through the passing of ordinary and special resolutions (University of Manchester Innovation Factory, n.d.).

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 policy** is a crucial aspect of a company's **financial strategy** that affects its ability to attract investors and raise capital. According to European Patent Office, dividend payments have a significant impact on a company's financial performance, and firms that maintain a stable dividend pay-out policy have been found to outperform those that do not. EPO also found that a company's dividend policy is influenced by several factors, including its growth potential, cash flow, and financial leverage. Additionally, companies that have a stable dividend pay-out policy are viewed as **less risky investments** by investors. Therefore, a company's dividend policy should be carefully planned and reviewed regularly to ensure that it aligns with its overall financial objectives and maximizes shareholder value (EPO, 2021).

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 (University of Manchester Innovation Factory, n.d.).

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 (University of Manchester Innovation Factory, n.d.).

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-off 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 (University of Manchester Innovation Factory, n.d.).

Your institution may also be deemed to be a “shadow director” if the spin-off 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-off on a management basis (University of Manchester Innovation Factory, n.d.).

Executive and Non-Executive Directors

According to the European Commission's Directorate-General for Research and Innovation (2022), the composition of a company's board of directors should reflect a **mix of executive and non-executive directors**. An early-stage spin-off may have a greater proportion of non-executive directors, while later stage companies tend to have more executive directors. Executive directors, who hold specific management roles such as Managing Director, Finance Director, or Sales Director, are also expected to

contribute to board sessions in a strategic capacity. Non-executive directors, on the other hand, bring commercial experience and independent judgement to the board, and may be appointed by an investor as a nominee director. However, they owe the same **fiduciary duties** to the company as executive directors. Non-executive directors may take an active role in areas such as audit reviews and remuneration, and the Chairman of the Board is typically drawn from the non-executive directors to provide balance and objectivity in leadership. It is generally recommended that the Chairman not hold the position of Managing Director to avoid conflicts of interest. Service contracts and letters of appointment typically set out the terms of employment and role of executive and non-executive directors, respectively.

Directors' Powers

According to the European Commission's Directorate-General for Research and Innovation (2022) directors of a company have the power to manage the business of the company and to exercise all the powers of the company itself, as granted by the **Articles of Association** ("Contrato Social" in Portuguese). This includes the power to enter into contracts with third parties, which may create an apparent authority for the director, even if it was not explicitly granted. However, it is important for directors to ensure they have both actual authority from the company and are clear that they are acting on behalf of the company, rather than personally.

In terms of decision-making, the board of directors usually takes decisions on a **majority voting system**, with the chairman having a casting vote in the event of a tie. While the chairman is nominally chosen by other board members, in cases where third-party funders are involved, they may insist on the right to appoint the chairman. Nonetheless, the director's first duty is to the company, and they should be chosen based on 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 (i.e., 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 (University of Manchester Innovation Factory, n.d.).

Director's 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 that directors should take into account are (University of Manchester Innovation Factory, n.d.):

- 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 (University of Manchester Innovation Factory, n.d.).

Wrongful Trading

According to the European Commission's Directorate-General for Research and Innovation (2022), the duties of a director are crucial, especially when it comes to the **potential insolvency** of a company. If a director becomes aware, or should have been aware, that there is no reasonable prospect of the company avoiding insolvent liquidation, they have a duty to act. This duty considers the director's general knowledge, skill, and experience. The director must inform the board of the insolvency and ensure that every possible step is taken to minimize the loss to creditors. Failure to fulfil this duty may result in the director being personally liable to pay into the pool of assets to be distributed to the creditors of the company.

Penalties

The duties and responsibilities of a director are critical, and the consequences of wrongdoing can be severe, including financial and criminal penalties. Unlike shareholders, directors have **extensive duties** and can face disqualification from acting as a director if the company becomes insolvent. However, if a director acted honestly and reasonably and the circumstances of the case merit it, a court may excuse the director from liability. Therefore, it is crucial for a director to act in the best interests of the company and consider the long-term consequences of their decisions, while complying with internal management issues such as accounting records and filing documents with the Registrar of Companies. Directors must also consider the interests of employees, suppliers, customers, the community, and the environment. In situations where the company is facing insolvency, a director must take steps to minimize the loss to creditors. In short, being a director requires significant expertise and responsibility (European Commission Directorate-General for Research and Innovation, 2022).

How to 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).

Source: (University of Manchester Innovation Factory, n.d.)

Funding

There are several sources that may provide funding. Some funding may be in the form of property provided for a brief term by your institution. Depending on your financial situation, you could be able to support yourself financially, or you might have family and friends who are prepared to do so. You will almost probably need to go to other sources of capital. (University of Manchester Innovation Factory, n.d.).

Investors invest their money, always expecting for a **short or long-term return**. In the vast majority of the cases, investors hope to make a considerable profit because investing in a new company is considered a **risky investment**. These are a few examples of potential investors: your research institution; business angels; venture capital organizations.(University of Manchester Innovation Factory, n.d.).

1. Research Institution

It is common for research institutions to take a **stake** in a spin-off company in return for various contributions, such as IP rights, infrastructure support, and the use of the institution's name. The Technology Transfer Office (TTO) or IP commercialization organization may hold this shareholding on behalf of the institution. In some cases, the research institution may make a capital investment at the start-up stage to support proof-of-concept objectives or to attract an early investor. It is important to note that the research institution will expect to be kept informed about the spin-off company's activities, and this can be achieved by including specific provisions in the Shareholders Agreement or by having a representative on the spin-off board. The nominated representative should have market experience with spin-off activities or be a member of the TTO or IP commercialization organization's board (University of Edinburgh, n.d.).

2. Business Angels

Individual investors are often attracted to spin-off companies because they can obtain a **substantial stake** in exchange for taking a **substantial financial risk** in the early stages of a company's life. These investors usually have busy schedules and entrepreneurial personalities, and they are unlikely to want any **management or board involvement**. However, they may like to offer ideas, make sure the founders are enthusiastic and committed, and informally provide contacts for additional investment or business opportunities. Therefore, there is typically no formal relationship between business angels and the spin-off. Still, they will be very interested in how their money will be used. It is common for "angels" to ensure that fair compensation and option plans are in place by examining copies of employment and service contracts and periodically receiving updates (University of Edinburgh, n.d.).

3. Venture Capitalists

Venture capitalists are specialized lenders who seek high returns on their investments and frequently have **minimum requirements for investments**. This may include that the company has reached a certain stage, has successful management, operates in a particular market sector or technological field, and has a minimum potential scale of returns. The investment capital provided by venture capitalists is often

contingent upon the achievement of predetermined milestones, and subsequent funding is withheld if specific milestones are not achieved, or activities are not successfully accomplished. This type of investment is commonly known as a "drip-feed" investment (University of Edinburgh, n.d.).

Venture capitalists expect the founders to invest their own funds as well, as this provides the investors with more assurance that the founders are committed to the project. Venture capitalists anticipate that founders will invest their funds in their shares and receive their compensation as a result. They do not support founders collecting significant consultancy fees, as this is perceived as withdrawing money before everyone else. The **rise in share value** is viewed as the reward for all stakeholders, and venture capitalists desire that all stakeholders be invested in the project and working towards the same goal (University of Edinburgh, n.d.).

The Shareholders' Agreement may be extensive due to the demand for specific objective goals and the assessment of progress. Venture capitalists will not be actively involved in the management of the firm but will be eager to support it by offering contacts and knowledge. However, they would likely expect limitations on many of the management's freedoms to act without consultation or permission and to have a vote in the composition of the board (University of Edinburgh, n.d.).

Dealing with investors

Notwithstanding the fact that not every spin-off will involve **investors from all categories**, it is possible that they will. As a result, by the time a venture capital firm has invested, in addition to the research initiators, there may be new "groups" of shareholders and a completely new and complex set of paperwork prepared as opposed to when the company was originally founded (University of Manchester Innovation Factory, n.d.).

You would benefit from seeking **expert guidance** along the route because the interactions and agreements with each of the parts can be complicated. It is very probable that your institution has a **public policy** outlining the distribution of shares between you and the institution (University of Manchester Innovation Factory, n.d.).

The next stage

All parties participating in the spin-off firm want to see the business expand so that the company's worth and the value of the shares owned by shareholders both rises. Nevertheless, every investor's ultimate objective is to achieve the value of their shares by pursuing what is known as an exit, which is often accomplished through (University of Manchester Innovation Factory, n.d.):

- the transfer of all of the company's issued shares to a third party, often a trade buyer
- the listing of the company's shares

Yet before the business has developed to the point where an exit is conceivable, more capital is probably going to be needed. While current shareholders may provide this cash, it is more typical for spin-off companies to search for investment from other sources. This may come from **Venture Capitalists or Business Angels** (University of Manchester Innovation Factory, n.d.).

A **Shareholders' Agreement** will still be applicable since the new Investor is going to become a shareholder in the business. Yet, as was already indicated, the Investor is likely to have its own standard form documents that it would expect to serve as the foundation of the new agreement and replace the one that was signed when the firm was just getting off the ground. This is probably going to have more stringent requirements than what was anticipated at the spin-out stage. This is especially true in light of the following areas (University of Manchester Innovation Factory, n.d.):

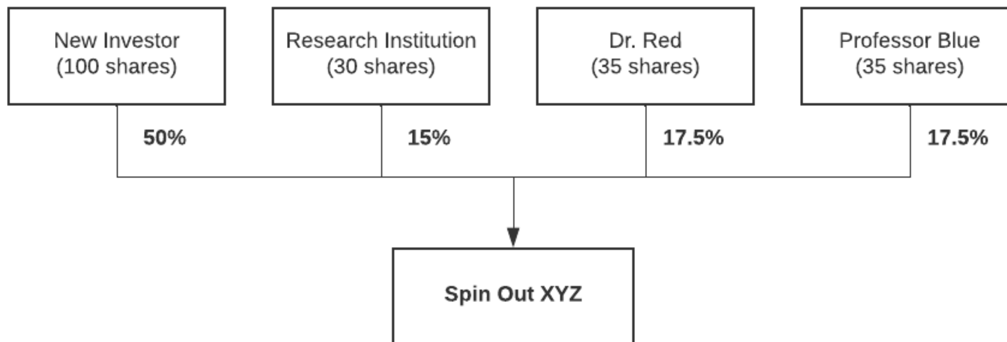
- **Warranties.** “The investor will seek assurance that the management team is ready to stand by the important information documents it would have relied upon when opting to invest before committing cash to the project. This will specifically pertain to the company's business strategy and due diligence reports. Attempt to negotiate restrictions to reduce your exposure in certain situations, such as a financial liability ceiling. Consider the type of any guarantees you will be providing and if you will be required to guarantee the company's future performance before agreeing to anything. Moreover, you must make the

Investor aware of any circumstances that render the warranties invalid by creating a Disclosure Letter and submitting it to them. You should notify the Investor through the Disclosure Letter if, for example, there is an assurance that the firm is not involved in any litigation, but you are aware that the company is being sued by a creditor”.

- **Consent Matters.** “The list of consent-related issues is probably far longer than what was anticipated during the spin-off stage. Although, the investor may invest a substantial sum of money in the firm, it is still important to strike a balance between the operational flexibility the management team needs to operate the business successfully and the controls the investor demands of them”.
- **Information. “**Compared to what was needed at the spin-off stage, the Investor is likely to want more specific information. For instance, reports on current trading, updated predictions, and the company's performance in relation to financial covenants contained in any banking documents may be required in addition to the monthly management accounts. Consider the logistics of being able to deliver the necessary quantity of information within the timelines anticipated by the Investor”.
- **Restrictive Covenants. “**The investor will anticipate that the company's main executives will devote all of their time and attention to achieving the growth anticipated in the business plan. It will also anticipate that any departing employees won't start a business that competes with it for a while after their employment ends. An investment agreement's restriction term will probably last between one and three years. A service agreement's duration beyond 12 months is unlikely to be upheld”.
- **Good and Bad Leaver. “**You could be required to send a transfer notice regarding the shares you hold if you resign your position. Your exit from the company may have an impact on the price at which you can sell those shares. So, the discussions with the Investor about what makes a good leaver may take a while”.

Reduction in Original Shareholding (Dilution)

The principal result of adding new shareholders to the company is that **additional**



shares will be granted to them, diluting the ownership of the original shareholders, including yourself. If there are 100 shares outstanding and you possess 35 of them, for instance, you will own 35% of the company. In the event that an additional 100 shares are issued to new investors, you will only possess 35 of the total 200 shares in circulation, or 17.5% of the company (University of Manchester Innovation Factory, n.d.). The first stance was as follows, using the example in Figure 1.

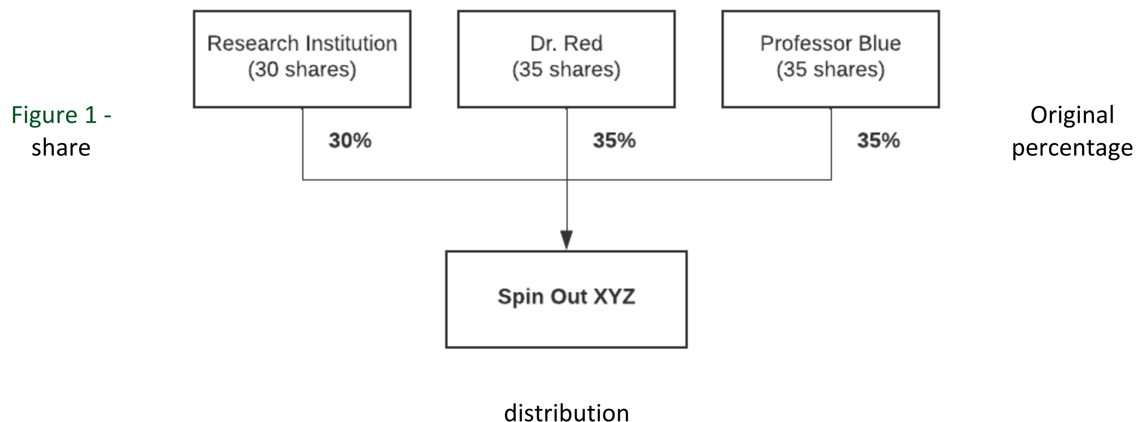


Figure 1 - Original share percentage distribution

Source: (University of Manchester Innovation Factory, n.d.)

If a new shareholder purchases 100 additional shares of your spin-off, their new shareholdings will be as follows (Figure 2):

Figure 2 - New share percentage distribution

Source: (University of Manchester Innovation Factory, n.d.)

The challenge for the original shareholders is what advantages the **new investment** will provide in exchange for their having their shareholdings diluted. Will the investment, for instance, give the company with the infusion of capital it needs to move forward with its development? Keep in mind that your company might need a **number of rounds of further funding** to expand and grow to the point where an exit can be considered. Such additional financing rounds will inevitably result in more dilution. For this reason, it is wise to set aside a particular number or proportion of shares for important individuals who will assist the spin-off succeed but have not joined yet. Often, this equates to around 10% of the company's issued shares (figure 3). It is referred to as an "option pool," and when the shares that have been theoretically assigned to such a pool are assigned, it will also cause dilution (University of Manchester Innovation Factory, n.d.).

In the end, having a **small piece of a big pie** is preferable to getting a huge piece of a tiny pie that has no value at all, which is what could happen if you decide against greater investment because of the **dilution impact**. Contemplate that it will also raise the issue of the company's **valuation** at each new fundraising round. Determining a valuation will be crucial since the company will be attempting to get as much money as possible from the Investor while transferring as little stock as conceivable. On the other hand, the Investor will be advocating for the highest proportion shareholding possible. Fixing an actual valuation will require a number of **complex considerations**, not the least of which is the investor's willingness to pay for the shares and at that point, the

corporation must consult **corporate financiers for advice** (University of Manchester Innovation Factory, n.d.).

Company documentation

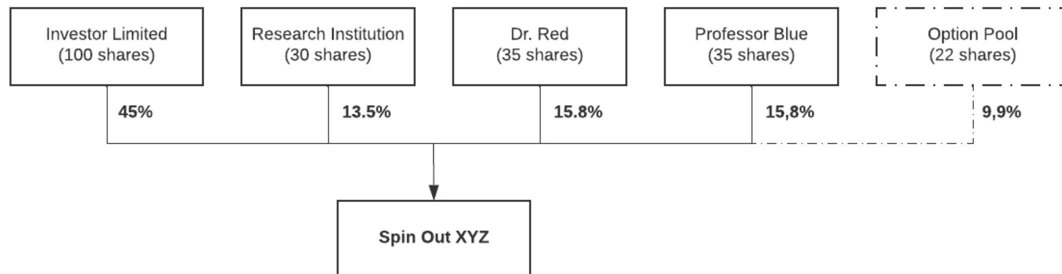


Figure 3 - Option pool and its effect on the percentage of shares

Source: (University of Manchester Innovation Factory, n.d.)

Once the company is structured, the number of shares each party will own, and the funding have been determined, it is essential to draft a **shareholder's agreement and the company's articles of association** ("Contrato Social" in Portuguese). The shareholder's agreement is a legal document that sets out the rights and obligations of the company's shareholders, while the articles of association define the company's internal regulations and structure. These documents are crucial for the smooth functioning of the company and should be carefully prepared to avoid any future disputes (University of Edinburgh, n.d.).

Some of the common clauses that appear in these documents include the purpose of the company, the powers of the directors, the issuance and transfer of shares, dividend payments, and dispute resolution mechanisms. It is important to note that these **clauses** should be drafted in a **clear and concise manner** to avoid any confusion or misinterpretation (University of Edinburgh, n.d.).

The primary objective of these documents is to provide a **framework for the relationship between the parties involved** in the company's operations. In addition to this, they also safeguard the investor's money by defining the procedures for the issuance and transfer of shares and the payment of dividends. Therefore, it is crucial to seek **legal advice** and ensure that these documents are prepared carefully and

comprehensively to protect the interests of all parties involved (University of Edinburgh, n.d.).

Shareholders’ Agreement

Fundamentally, the Shareholders' Agreement is a written instrument that delineates the **conditions** under which the involved parties will acquire shares in the enterprise. It includes provisions regarding the amount of shares that each party will obtain and the corresponding price for each share. Additionally, it specifies the primary stipulations that govern the relationship among the shareholders and their operations within the business after the capitalization process has concluded. These provisions are designed to provide safeguards for investors and generally cover the following aspects (University of Manchester Innovation Factory, n.d.):

- **Information.** In order to monitor the company's progress, an Investor will need access to both financial and management data. The Shareholders' Agreement will typically outline the details regarding the Investor's entitlement to receive monthly management accounts, statutory accounts, minutes from board and shareholder meetings, and any other relevant information pertaining to the enterprise that the Investor may reasonably request. Additionally, the Investor will generally require that formal financial budgets for each fiscal year be prepared and approved in advance. These data points are necessary for the Investor to fulfil its responsibility of overseeing its investments. If issues arise within the business, the Investor can intervene early on and provide guidance to the management team to assist in correcting the course of the enterprise.
- **Investor director.** A significant Investor typically desires the right to appoint or remove a representative to the Board. The Investor Director may hold increased voting power, particularly if the company fails to fulfil fixed dividends or takes actions that require the Investor's authorization. This right is not usually necessary, however, if the Investor already owns a majority of the shares. A fee for the Investor Director's services, which is paid by the company, is often levied. The amount and structure of this fee can vary greatly. In some instances, this may be addressed in a

separate services agreement between the Investor and the company, particularly during the spin-off stage. The Investor may also provide accounting and administrative services to the company as it gets off the ground.

In order to oversee the decision-making process of the board, an Investor may mandate that the presence of the Investor Director is necessary to achieve a quorum at board meetings. This approach allows the Investor to actively participate in the decision-making process and provide input into the board's deliberations.

- **Observer.** As a matter of course, an Investor will often request that an individual, who may or may not have the authority to participate in discussions, attend all board meetings as an Observer. This person is not typically a director and does not have voting rights.
- **Restricted Acts.** It is customary for an Investor to outline specific matters that require their prior approval before the company can act. These matters are typically referred to as "Restricted Matters."

In essence, the Investor is aiming to safeguard the value of their investment by ensuring that the company does not make significant decisions without their agreement. This helps to ensure that the Investor has a say in important matters that could affect the value of their investment.

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

Source: (University of Manchester Innovation Factory, n.d.)

It's possible that the management team of the company could face limitations on competing against the company, such as refraining from soliciting customers or staff members for a certain period after their departure from the company as an employee or director (University of Manchester Innovation Factory, n.d.).

These types of restrictions may not be requested during the spin-off phase, especially if you're staying on as an employee of the research institution. However, they may become necessary later on, particularly if external investors become involved in the company (University of Manchester Innovation Factory, n.d.).

When an Investor invests in a company, they will typically want to ensure that they are protected in case something goes wrong. One way in which they can achieve this is by seeking **warranties from the management team**. These warranties may cover a range of important areas, such as the accuracy of information in key documents, the personal standing of the management team, and the health of the business itself. It is worth noting that warranties are not always requested at the early stages of a company's development, but as external investors become involved, they may well be required. Therefore, it is important for the management team to be aware of the possibility of providing warranties in the future (University of Manchester Innovation Factory, n.d.).

To mitigate the financial risk of potential lawsuits, the management team will typically seek to **minimize their liability when giving warranties**. This can be done by establishing a threshold amount for a claim to be brought and by setting a time limit for bringing such claims. Additionally, each manager may set a cap on their personal liability,

often based on a multiple of their annual salary, to limit their financial exposure (University of Manchester Innovation Factory, n.d.).

It's important to note that the Shareholders' Agreement made during the initial stages of a spin-off may not remain valid as the company progresses and attracts new investors. As new funds are provided and different investors become involved, it is common for venture capitalists to introduce their own forms of Shareholders' Agreements, which they typically require the company to adopt (University of Manchester Innovation Factory, n.d.).

Articles of Association ("*Contrato Social*" in Portuguese)

The Articles of Association ("*Contrato Social*" in Portuguese) are a key document in outlining the specific **rights and restrictions attached to each type of shares** issued by the company. Investors may choose to subscribe for a different class of shares than the management team, with preferential rights such as priority access to dividends or special voting powers. These rights and restrictions are outlined in the Articles to protect the Investor's investment and may require the Investor's prior consent for certain matters. Additionally, the Articles may specify the Investor's ability to appoint or remove an Investor Director, and the quorum for board meetings, which may require the Investor Director's presence. Furthermore, the Investor may impose limitations on members' ability to transfer their shares in the company, which can also be detailed in the Articles (University of Edinburgh, n.d.).

Investor's Preferential Rights

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

Permitted transfers

At the spin-off stage, it is typical for the shareholders' agreement to contain **restrictions on the transfer of shares** without the Investor's consent. This is often a

simpler solution to prevent unwanted transfers of shares. However, in some complex cases, the Articles of Association ("*Contrato Social*" in Portuguese) may allow certain transfers of shares without having to offer them to other members first. These transfers may include those made within the same group of companies, to immediate family or family trusts, and with the Investor's prior approval. It's important to note that in such cases, the permitted transferee may be required to transfer the shares if they no longer meet the necessary criteria, such as leaving the transferor's group. This ensures that the company's ownership remains within the intended group of shareholders (University of Edinburgh, n.d.).

Compulsory transfers

It is common for an Investor to require founders to **offer their shares back** to the company or other shareholders if they are no longer associated with it. This requirement can be enforced through **compulsory transfers**, which can be triggered by the shareholder's departure as an employee or director. To determine the value of the shares, an independent assessor such as a corporate finance accountant can be used. However, the Investor may choose to reduce or waive this requirement if the founder has spent a significant amount of time with the company after the investment. The Articles of Association can specify the basis for calculating the sale price of shares on a compulsory transfer, which may be based on factors such as performance or length of service (University of Edinburgh, n.d.).

Performance-Based Test

Distinguishes between good leavers and bad leavers. 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 (i.e., not a good leaver) he/she may only get the lower of market value and the original cost of his/her shares.

Source: (University of Manchester Innovation Factory, n.d.)

Time-Based Test

This provision stipulates that if a member of the management team departs from the company prior to a predetermined date, regardless of the circumstances surrounding their departure, their shares will be evaluated under the assumption that they are a negative influence on the company. Conversely, if they leave after the agreed-upon date, they will always be regarded as a positive asset to the company.

Source: (University of Manchester Innovation Factory, n.d.)

General transfer mechanism

Typically, when transferring shares, it is customary to provide advance notice of the intention to transfer to all other shareholders. This affords them the chance to purchase a portion of the shares equivalent to their current shareholdings in the company. Additionally, a pricing mechanism will be in place.

Exit arrangements

The Articles of a company may address the terms for exiting. Among the topics typically addressed are the rights of "drag along" and "tag along".

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 member from realising their investment or seeking a disproportionate share of the proceeds as a “ransom” position. These are sometimes known as “come along” rights.

Source: (University of Manchester Innovation Factory, n.d.)

Tag Along

The "tag along" provision ensures that if a shareholder receives an offer for their shares, they must extend the same offer to other shareholders in the company. This gives all shareholders the chance to sell their shares to the third party simultaneously and at the same price before any one shareholder can sell their shares. This is crucial

for shareholders with smaller holdings as they may be left with their shares while the majority shareholders exit. "Tag along" rights are sometimes referred to as "come along" rights, which can cause confusion.

Source: (University of Manchester Innovation Factory, n.d.)

Tax Issues

The creation of a spin-off company could give rise to several potential tax-related concerns.

Income Tax on the Acquisition of Shares

When researchers obtain shares in a company, proper institutions may consider the shares to be acquired through their employment, and thus subject to income tax if their value exceeds the price paid to acquire them. Injecting assets and cash into a company can increase **the risk of income tax liability**, as the shares may have a value that exceeds their nominal value. However, a tax exemption may apply to the value of any IP transferred for researcher shareholders (University of Edinburgh, n.d.).

To avoid an income tax charge, it is important to pay at least the **market value for shares**. If assets or cash are contributed to the company, they should be used as payment for the shares. Investor or research institution may receive shares with superior class rights, which could potentially reduce the value of your shares. If shares are acquired for free or for a nominal fee, it is important to determine if you are liable to pay income tax on them (University of Edinburgh, n.d.).

Future Charges to Income Tax

Restricted shares refer to shares that are acquired with certain **limitations** that can **reduce their overall value**. These limitations can impact the holder's ability to keep the shares, such as through compulsory transfer provisions, or can restrict certain rights attached to the shares, such as the ability to transfer, receive dividends, or exercise voting rights (University of Manchester Innovation Factory, n.d.).

As a researcher, if you acquire "restricted shares" in a company, you may face potential income tax charges in the future. If you make any financial gains from your

shareholding, the "restricted share" laws can increase the portion of those gains subject to income tax instead of capital gains tax. Additionally, taper relief and the annual exemption may significantly decrease the overall effective tax rate for higher rate capital gains taxpayers (University of Manchester Innovation Factory, n.d.).

In the case of restricted shares, income tax charges may arise in the future upon the sale of the shares or the removal of their restrictions. At that time, a portion of the shares value may become subject to income tax, equivalent to the proportion of the market value that was impacted by the restrictions (University of Manchester Innovation Factory, n.d.).

When acquiring restricted shares, it's advisable to seek **legal advice** that's specific to your situation. There is an option for employers and employees to jointly elect to have the shares considered unrestricted under **tax legislation**. Such an election may increase the initial income tax charge, but researchers may be exempt from this tax. Capital gains tax would apply to the increase in share value upon sale, and if no election was made, when restrictions are lifted (University of Manchester Innovation Factory, n.d.).

Share Options

Issuing shares at nominal value, as previously described, involves an **immediate transfer of equity ownership in the company**. However, this may not be ideal in every scenario as it can result in a **loss of control over the company** due to dilution (University of Manchester Innovation Factory, n.d.).

Another option is to utilize share options, which grant employees the right to acquire a specific number of companies shares at a future date, often triggered by a certain event such as a sale or takeover. This approach can incentivize employees without immediately giving away any equity. If the employee leaves before being eligible to exercise the option, it will lapse, eliminating the need to reclaim any shares. Certain types of share options may offer tax efficiency benefits (University of Manchester Innovation Factory, n.d.).

Why use share options?

- to attract key employees to the company and encourage them to remain with the company
- to incentivise employees (e.g., 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-off companies

Source: (University of Manchester Innovation Factory, n.d.)

Tax and the Company

As a separate legal entity, the company is taxed independently and is subject to corporation tax on its profits. The accounting period is set when the company is formed, and profits are calculated based on this timeframe. The company must submit a self-assessment tax return within 12 months of the accounting period's end. In the early stages, the company's allowable expenses may exceed its total turnover, resulting in tax losses instead of profits. Consequently, no corporation tax would be owed (University of Manchester Innovation Factory, n.d.).

A new company may opt to obtain insurance coverage to mitigate the potential financial impact of losses or damages to its assets or liabilities incurred during its operations. Insurance arrangements may be influenced by investors who require specific insurance policies to be implemented before investing in the company (University of Manchester Innovation Factory, n.d.).

Certain types of insurance, like employers' liability and third-party motor liability, are mandatory while others, such as public and product liability or material damage, may not be compulsory but may be necessary. It is advisable for companies to identify their assets and potential liability exposures early on and seek professional advice to determine the appropriate level of insurance coverage needed (University of Manchester Innovation Factory, n.d.).

"Keyman" insurance

"Keyman" insurance is a type of coverage that protects a spin-off from the costs of incapacity, illness, or death of its key personnel, who are crucial to the success of the

company, particularly in its early stages. This type of insurance is often required by Venture Capitalists investing in the spin-off.

Source: (University of Manchester Innovation Factory, n.d.)

Directors’ and Officers’ insurance

Directors and officers of a spin-off company may consider obtaining Directors' and Officers' insurance (D&O cover), which can protect them against losses resulting from claims made against them in relation to their duties as directors or officers. This type of insurance typically provides cover for both the company and individual directors and officers, although it does not cover criminal liability.

Before obtaining a Directors’ and Officers’ policy, it is important to carefully review and assess it to ensure that it provides sufficient protection for the risks faced by the company's directors and officers.

Source: (University of Manchester Innovation Factory, n.d.)

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