



LEGAL CONSIDERATIONS FOR START-UP COMPANIES IN NIGERIA

One of the most paramount questions on the mind of every entrepreneur on the verge of starting their own business or intending to expand their business is how to raise capital. This article seeks to consider the various types of financing options and the legal considerations that are available to start up businesses and companies with the desire to expand in Nigeria.

Types of finance

Investing in a relatively new company is a risk which may deter some traditional forms of finance. It involves investors taking a longer term view on their investment, particularly where there is a large amount of research and development to be funded, before any income will be received.

Finance falls into two main categories:

- Equity financing
- Debt financing

Whatever the type of finance given, investors will want to carry out appropriate financial and legal due diligence to check the company and its affairs are in good shape. This will include checking the appropriate paperwork is in place, filings have been made at the Corporate Affairs Commission, intellectual property rights are properly vested in the company, key contracts are properly documented, there are suitable employment contracts for key individuals etc.

What is equity financing?

Equity finance is the most common source of funding for small companies. The person starting the business will normally introduce equity capital, but equity capital can also be raised from external investors like friends, family and venture

capitalists. If the business is a company, the equity is invested in exchange for an interest in the company (shares). Investors also expect a portion of the business's profit, which in the case of limited companies takes the form of dividends. Equity finance is more risky than debt finance as shareholders are paid back only after other creditors in any insolvency of the company. Investors will also be looking for a good return when they sell their shares. Equity is best suited, therefore, to businesses that expect to grow quickly.

The distinction between debt and equity is further blurred by the use of instruments such as convertible loan stock which is a form of debt that is convertible into equity on certain terms.

Some Important Considerations

1. Share Price – Valuation is key to determining the number of shares that would be allotted to the Investor.
2. Board representation – The Investor may also require a representation on the Board of the company essentially to protect the Investor's interest. Ideally any board member should add value to the company by way of knowledge, experience and contacts, and not merely act as an observer for the investor.
3. Share structure – Investors commonly want a substantial minority (ie, less than 50 per cent but greater than 25 per cent) which enables them to block a special resolution (many key decisions require the consent of 75 per cent or more of the shareholders). Consider which shareholders, or which combinations of shareholders voting together, can pass ordinary resolutions which require greater than 50 per cent of voting shares.
4. Preferential return – Investors often want a priority return on their investment either through the use of preference shares with a priority dividend or more commonly through “A” ordinary shares which have a priority return on exit events, usually a sale, float or liquidation of the company termed a “liquidation preference”.

5. Veto rights – investors often wish to enhance their position as minority shareholders through veto rights on key decisions for example:

- a. changes to share rights;
- b. changes to Memorandum and Articles of Association;
- c. expenditure over certain thresholds;
- d. issue of further shares or options;
- e. disposal of assets;
- f. employment of staff or staff over a certain salary;
- g. changes to terms of directors' employment(including salary);
- h. changes to the nature of the business;
- i. capital expenditure over a certain threshold.

6. Equity investors will also want to see a clear route for 'exit' – a realisation of their investment usually within Three to Five years. The usual means of achieving this are seeking a listing of the shares on a recognised exchange, seeking a trade sale or carrying out a refinancing. The investors' desire for an exit may not always entirely coincide with the directors' views of the direction the company will take.

What is debt financing?

Debt finance could usually be short term or long term. Debts are repaid over a period of time, at fixed or variable rates of interest. The lender has no equity stake in the company although a lender may require the ability to convert debt into equity on the occurrence of certain events.

The lender will usually require that the debt be secured by a business or personal asset. Terms can vary in length from one year to 25 years, and will usually be determined by the asset that is being financed. The interest rate will reflect the lender's perception of the risk in providing the debt. Short term Debt financing can be provided in the following ways:

1. An overdraft is money that a business can borrow from a bank up to an agreed limit. It provides a business with short-term financing, effectively by running a negative balance on the bank account. This is a particularly good way of funding short-term requirements, such as providing working capital during the course of each month.
2. Term loan is a fixed sum is lent for a fixed period, usually repayable in instalments, but once repaid cannot be redrawn.
3. Revolving credit is a fixed sum is lent for a fixed period, but is available in tranches which can be repaid and drawn down again, giving greater flexibility.
4. Loan note/bond is a fixed sum advanced for a fixed period, but the holder of the note or bond can transfer the benefit to a third party.

Lending may be secured or unsecured. Secured lending involves the lender taking a charge over certain assets of the borrower. This means that if a company defaults in repayment of the loan the lender can have recourse to the secured assets in order to satisfy the debt. The lender will rank ahead of unsecured creditors, such as trade creditors, and there is therefore a considerable advantage to it in taking security.

As a result, secured lending will typically be at a lower rate of interest to unsecured lending. Secured lending is more difficult for early stage companies as there are often very few assets of value in existence at that point.

Some important considerations

The precise terms of the lending should be carefully checked to consider issues such as:

1. The terms of repayment – can the company afford the repayments based on the income projections in the business plan?
2. Interest payable – what is the rate and is it in line with the market?
3. Right to repay early – are there any penalties for repaying early, for instance on a disposal or if you want to change banks?
4. Remedies for default – in what circumstances can the lender claim repayment?
5. Any ability to convert the debt into equity.
6. Covenants – are there restrictions on what the company can do without the bank's consent?

Key steps to take

- Consider the appropriate level of investment you require.
- Make sure your business plan is up to date and complete.
- Consider what level of investment is required and from whom (i.e. family, friends, banks or venture capitalists).
- Appoint legal advisers at an early stage. As well as drafting any relevant documents they can assist with contacts and advise on the contents and circulation of business plans and help in negotiating the heads of terms.

For more details please contact:

Oluseun Sodunke on 234 1 738 8369, 234 1 791 07 02
Email: oluseun.sodunke@bloomfield-law.com

Kunle Obebe on 234 1 738 8369, 234 1 791 07 02
Email: kunleobebe@bloomfield-law.com