Fundraising process for startups

EMANUEL ROTH SOARES
Coordinator of the venture capital and innovation team at MdME Lawyers

Fundraising is the process whereby a business raises the necessary capital from external investors to fund and grow its business. Startups often burn through cash at a rapid rate, operating at a loss for a long period of time as they seek to establish themselves on the market, so the fundraising process is a particularly significant part of the life of a startup, and will increasingly take up more and more time and attention of the founders as the business develops.

For startups or other fast-growing companies, fundraising typically happens in several stages (or "rounds"). Each successive round will raise more investment capital than the last, while the ownership (shares) of the founders in the company will be successively diluted (reduced) in each round as new investors gain ownership in the company. These investment "rounds" have common denominations such as "Angel", "Seed", "Series A" round based on the size of the investment or the stage in the company's growth.

In today's column we will outline the process of negotiating and concluding a successful fundraising round, as well as the key legal risks and matters that founders need to pay attention to.

1 - Pitching and Negotiating

Whether it's landing your first investor or navigating the complexity of later investment rounds, the first step will be convincing potential investors to invest in your business and negotiating the best deal possible.

For early-stage startups, a lot of effort will be put into convincing investors to buy into your project. This will typically involve the preparation of a "pitch deck" presentation for investors, outlining the business plan, growth potential and other key aspects of the business.

Once an investor is on board, the parties will typically negotiate and sign a Term Sheet. This is an agreement which outlines the key legal and financial terms of the proposed investment and is the basis for moving on to due diligence and finalizing the transaction.

2 - Due Diligence

After signing a Term Sheet, with both parties committed in principle to moving forward and finalizing the deal if certain conditions are met, the due diligence phase will involve the company providing information requested by the investor for review by their legal counsel and financial advisors. This information will typically include providing access to the corporate book-keeping of the company, financial documentation, key supplier or service contracts, as well a review of labour, litigation and compliance matters.

For early-stage startup companies, the type and extent of information which can be provided to investors at that stage in the company's growth may be limited, and investors will likely be focused on existing shareholder relations and whether the company's business model poses any serious regulatory or contractual risks.

For the founders, making sure the company is in good shape and compliant with its key legal and regulatory obligations before this stage is important to ensure a smooth due diligence process.

3 - Long Form Documentation

Once due diligence has been completed to the satisfaction of the investor, the parties will proceed to negotiate and finalize the long-form documentation required to complete the deal, which typically includes an investment agreement, shareholders agreements, changes to the articles of the company and other specific documentation required to implement the transfer of shares.

The main framework agreement to complete the investment will typically be an Investment Agreement or Share Purchase Agreement, which will set out the terms and conditions and the process for completing the investment and transfer of ownership in the company.

A few of the key legal clauses that the parties will negotiate for the Investment Agreement are:

- Conditions Precedent: These are the conditions which must be met (typically by the company) before the deal can be finalized. These typically include matters such as the resolution of serious ongoing legal issues or disputes facing the company, restructuring of the company's corporate structure, and obtaining prior approval from regulatory agencies (if required);
- Representations and Warranties: These are the statements of fact and assurances regarding the business and operations of the company. These are legally binding statements and the party giving them may be found to be in breach of contract and thus incur damages if they are found to by false or misleading;
- Voting and Management rights: The parties may agree on voting majorities required for making shareholders decisions, as well as the rules for managing the day to day operations company or the appointment of directors or managers;
- Vesting: Vesting is a contractual mechanism whereby the founders are contractually bound to remain with the company and "earn back" their ownership in the company over a period of years. This protects the investor from founders losing interest and leaving the company shortly after securing investment;
- Preference, drag and tag-along, non-dilution: There are a variety of contractual mechanisms which determine what are the rights of the parties when future investments, sale of shares or exits from the company occur. These are of fundamental importance and can eventually determine who will own the majority of or control the decision-making rights in the Company.

As can be seen, the details of the transaction agreements will impact the rights and obligations of the parties regarding the ownership and control of the business and of the responsibilities assumed by each party. Care should be taken when reviewing and negotiating these contracts, as specifics are important and make a fundamental difference in the long run.

Ultimately, founders should familiarize themselves with the ins and outs of the fundraising process, and this will help them to maximize their chances of success in sealing the deal as well as to prevent any issues further down the road. ■

This is the fifth in a series of articles offering practical legal tips for young entrepreneurs, to be published by the author in cooperation with the Macao Young Entrepreneur Incubation Centre, where he provides mentorship and consultation for its members.

IN PARTNERSHIP WITH
澳門青年創業孵化中心
Macao Young Entrepreneur Incubation Centre