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PITFALLS OF RAISING FINANCE

Raising finance for a business is at best a stressful exercise with numerous pitfalls and obstacles requiring careful navigation. If convincing a prospective investor that your business is a good place to invest their money is not hard enough, you also need to ensure that you are keeping within the numerous regulatory requirements (particularly bearing in mind the Financial Services and Markets Act 2000 and the new Companies Act 2006) and that the deal is properly structured.

Whilst "going it alone" without professional advice from accountants and lawyers may save fees in the short term, you could be creating greater problems for the future which could prove extremely expensive to unravel and can even prove fatal to a business.

Company Shares – "half full or half empty?"

One example of misguided creativity saw one company, try and issue fractions of shares. The company which was incorporated with an authorised share capital of £100 divided into 100 ordinary shares of £1 each, had three shareholders. Two of the shareholders were the founders and directors of the company the third was a silent investor. The company had purported to issue the following shares:

Shareholder A: 39.5 shares
Shareholder B: 39.5 shares
Shareholder C: 10.5 shares

The problem:

It is not possible to issue fractions of shares on allotment, where the share capital is divided into shares of £1, only whole shares of £1 can be issued. Fractional entitlements to shares can arise on certain occasions, for example, a "rights issue". In such a scenario if the rights issue is a three for two rights issue (meaning that shareholders who have two existing shares are entitled to subscribe for three new shares) then fractional entitlements will arise where shareholders have an odd number of shares. This will always be dealt with by the terms of the rights issue stating that fractional entitlements will be rounded up or down, and the articles will usually give the directors this power.

In addition, Table A of the 1985 Companies Act which governs most companies, to the extent not disapplied in a company's articles of association, sets out in Regulation 33 the power of directors "whenever as a result of consolidation of shares" to sell shares representing fractions for the best price reasonably obtainable. This indicates quite clearly that fractions of shares are recognised to exist by way of accident/procedure but need to be eliminated in order to create whole numbers again.

The Companies Act 1985 (the"1985 Act") unhelpfully has no definition of a "share", however, there is some implied

guidance to the nature of a share in section 80 which deals with directors' authority to allot shares. Section 80 states that the directors of a company cannot allot relevant securities unless they are authorised to do so. "Relevant securities" are defined as "shares in the Company". There is no reference to fractions of shares. Additionally section 2 of the 1985 Act which deals with requirements with respect of the memorandum of association, Section 2(5) (b) clearly states that no subscriber of the memorandum (first shareholder) may take less than one share. The new Companies Act 2006 (the "2006 Act") provides some further guidance by making clear that shares must have a "fixed nominal value" (Section 542(1)).

In order to maintain the pre-agreed percentage shareholdings, the parties could have either increased the share capital and issued further shares, or to have subdivided the existing £1 shares into share of say £.50 or £.01 which would have again eliminated any fractional entitlements. [How was it resolved?]

Had the situation been left unattended, shareholders could have found themselves with un-ascertainable interests in shares which they would make it extremely difficult if they wanted to sell their shares in the future.

Regulatory watchdog has teeth.

Most business will look to raise funds, either debt or equity, in conjunction with their accountants, lawyer and bank and the numerous regulatory restrictions are carefully followed. In some cases, a business can develop so rapidly and in circumstances that appear inoffensive to most observers only to find that the a regulatory body such as the Financial Services Authority coming down like the proverbial tonne of bricks.

One recent example involved a business that started life sending lists of properties coming up for auction to a number of subscribers. The attraction of playing the property market is an obvious one and given the number of television programmes devoted to the subject, it seems almost everyone is at it. It was not long before an innocent subscription service developed into a property developing business and soon subscribers to the auction lists and others were being invited to invest in various property opportunities. The business soon developed a property portfolio if [ ] properties with a value of c£[ ] and had raised money from [ ] investors.

The two partners in the business did seek some "off-the-cuff" advice as to whether they needed any regulatory approval, however this proved incorrect. Eventually, one prospective investor sought advice via an advice column of a popular Sunday newspaper which suggested that the business was involved in deposit taking and needed to be regulated by the FSA. The FSA then moved in, freezing the assets of the business and its two owners and bringing down the house of cards. The partners behind the business are now facing

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bankruptcy and investors have suffered heavy losses.

Clearly an in depth review of the business and its proposed methods of raising funds were needed as this would have highlighted the dangers.

Practical advice and how we can help:

When raising finance or issuing shares in a company, it is vital that professional advice is sought. This should include tax and accountancy advice on how any deal should be structured and legal advice to ensure that everything is properly documented in a way that complies with the relevant legislation and regulations. Where companies are issuing shares this can include preparing shareholders agreements and articles of association, reviewing loan and security documentation and ensuring that the necessary shareholder and board resolutions are completed and the relevant filings at Companies House are completed.

Fortune Law is a niche practice focusing solely on corporate and commercial legal advice. We have a wide and varied experience in corporate finance and have advised clients on a full range of corporate finance work including both public and private debt and equity, and initial public offerings.

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4th July 2007

Correct as of time of printing