

Edinburgh Research and Innovation

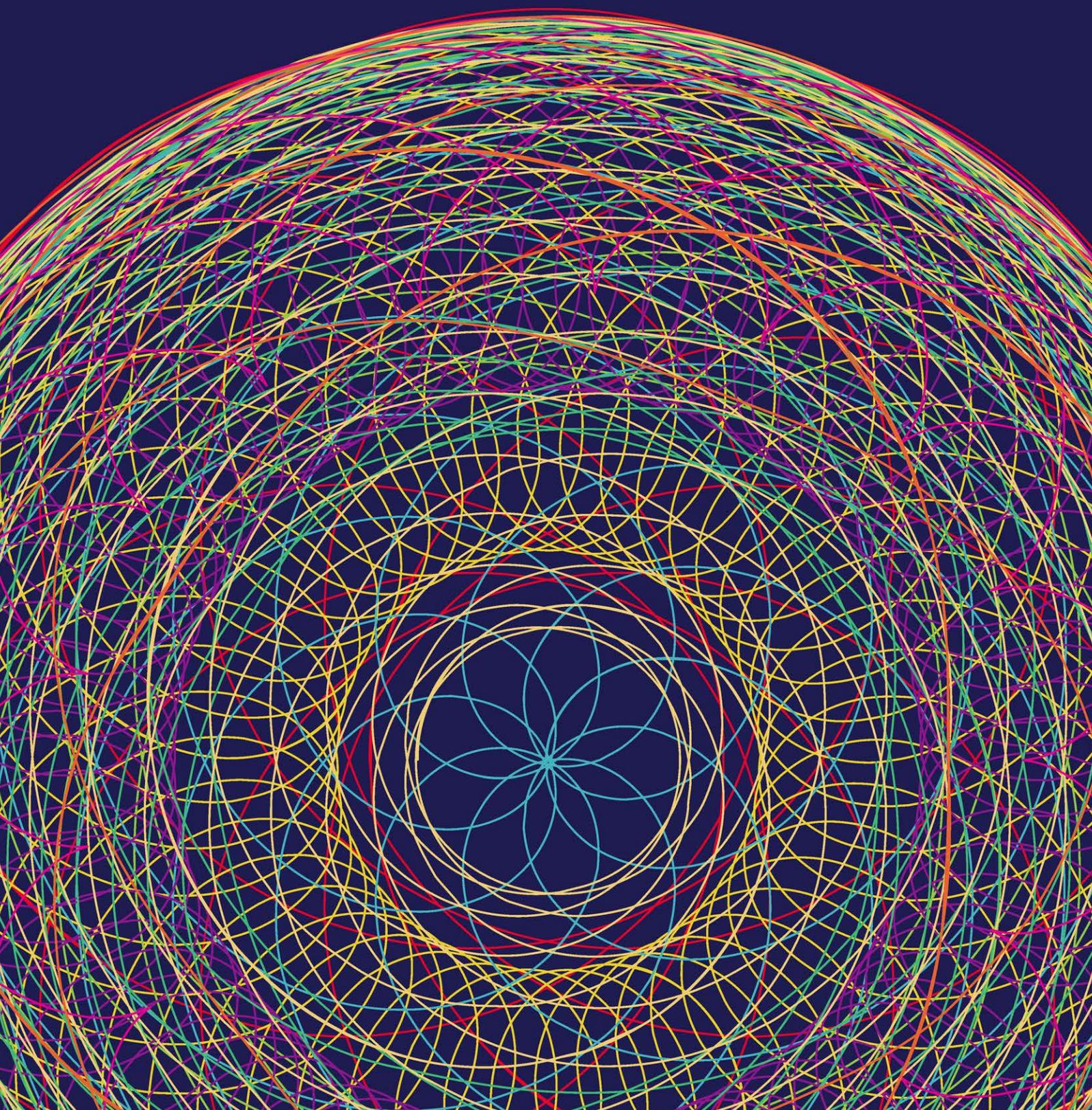
A UK leader in commercialising research and entrepreneurship



THE UNIVERSITY of EDINBURGH

# Spin-out Support Guide

University of Edinburgh



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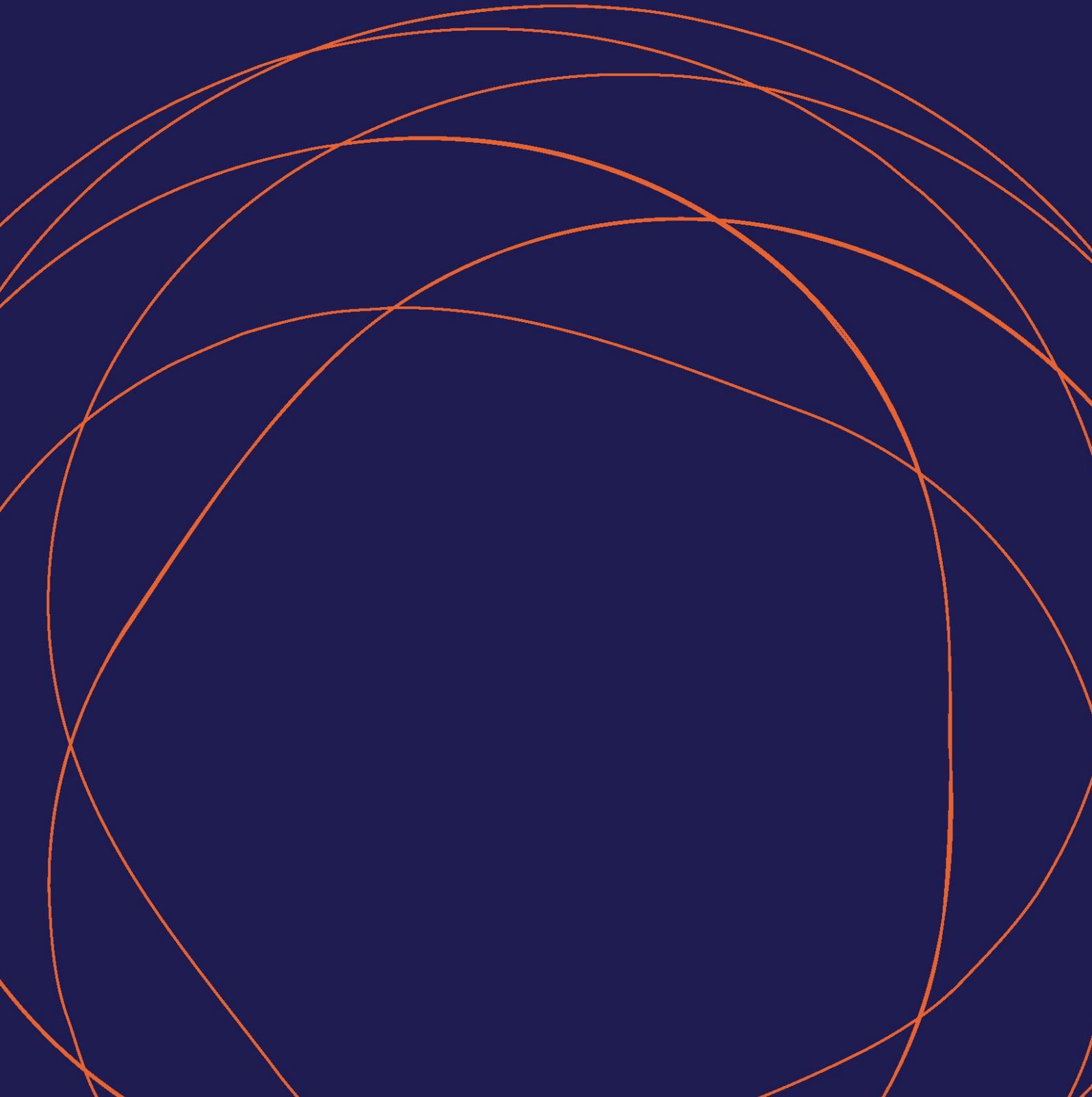
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# 1. A snapshot



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## 1.1. Why start a spin-out?

When research breaks new ground, there is the possibility that it may also provide an exciting new commercial opportunity. Forming a spin-out company is just one way to commercialise intellectual property (IP) and it is the route typically considered when there is no existing business to approach about the new IP or because the technology has clear potential to generate many products and engage multiple sectors. Such opportunities are known as platform or disruptive technologies. By taking a disruptive technology to market yourself, you can deliver real impact.

Setting up a new spin-out is a challenging and sometimes stressful activity that will distract you from your research. To create a successful business you will need to bring together various resources such as specialist management, facilities and funding (typically from a combination of investors, grants and customers).

Edinburgh Research and Innovation (ERI) is here to encourage and support enterprise among University of Edinburgh employees and students. We can advise and offer practical help to find the funding and facilities the business needs, and assist you to successfully work alongside investors and experienced management whose longer-term objectives may be different from your own.

Not all research is suited to becoming the platform for a new business and ERI can help to evaluate the opportunity arising from your research. It is never too early to speak to us about your ideas and we welcome your call. It may be that a 'proof of concept' project is needed within the University to further demonstrate the feasibility of your idea. Not only do we have access to in-house funds, but we can also work with you on longer-term incubation projects where further University-led funding is beneficial to enabling the exploitation of the technology.

## 1.2. ERI's contribution

ERI has supported University of Edinburgh researchers in the setting up of more than 24 spin-out companies over the last five years. Wolfson Microelectronics, MTEM and Vision are some of the big names to have emerged from the University with the help of ERI.

ERI has the expertise to support you at every stage in the process of setting up a company. Our goal is to help the company achieve and sustain growth, so it has the best chance of long-term survival and success. Our contribution covers five main areas, each of which is discussed in more detail in section 3:

- **IP management**
- **Business planning**
- **Market research**
- **Building your team**
- **Funding**

## 1.3. What's in it for the University?

The creation of a successful spin-out company is good for the individuals involved, the local and national economy, and the University. Our position as one of the world's top 20 universities relies upon our proficiency in conducting pioneering research. If we can also commercialise the IP that is generated from this research then the University stands to enjoy long-term financial as well as reputational rewards.

The University invests both IP and significant infrastructure and resources to support the set up – and ongoing success – of a spin-out company. In return, as an 'investor' of IP and other resources, the University receives equity in the business. It means that we don't charge a fee for our services and advice, and since the University is invested in the company's success, you can rely on ERI to do all that we can to help you to advance the company's interests.

## 1.4. How the process affects you

As the originator of the research you will be at the centre of the spin-out from the outset. You are likely to be one of the initial shareholders and you may play an active role in the company. You needn't be involved full time, however, in the short term it may be desirable for you to be seconded into the company to facilitate transfer and development of the technology within the company. In the longer term you may continue to serve as a visionary for others in the business, for example, by chairing the scientific advisory board.

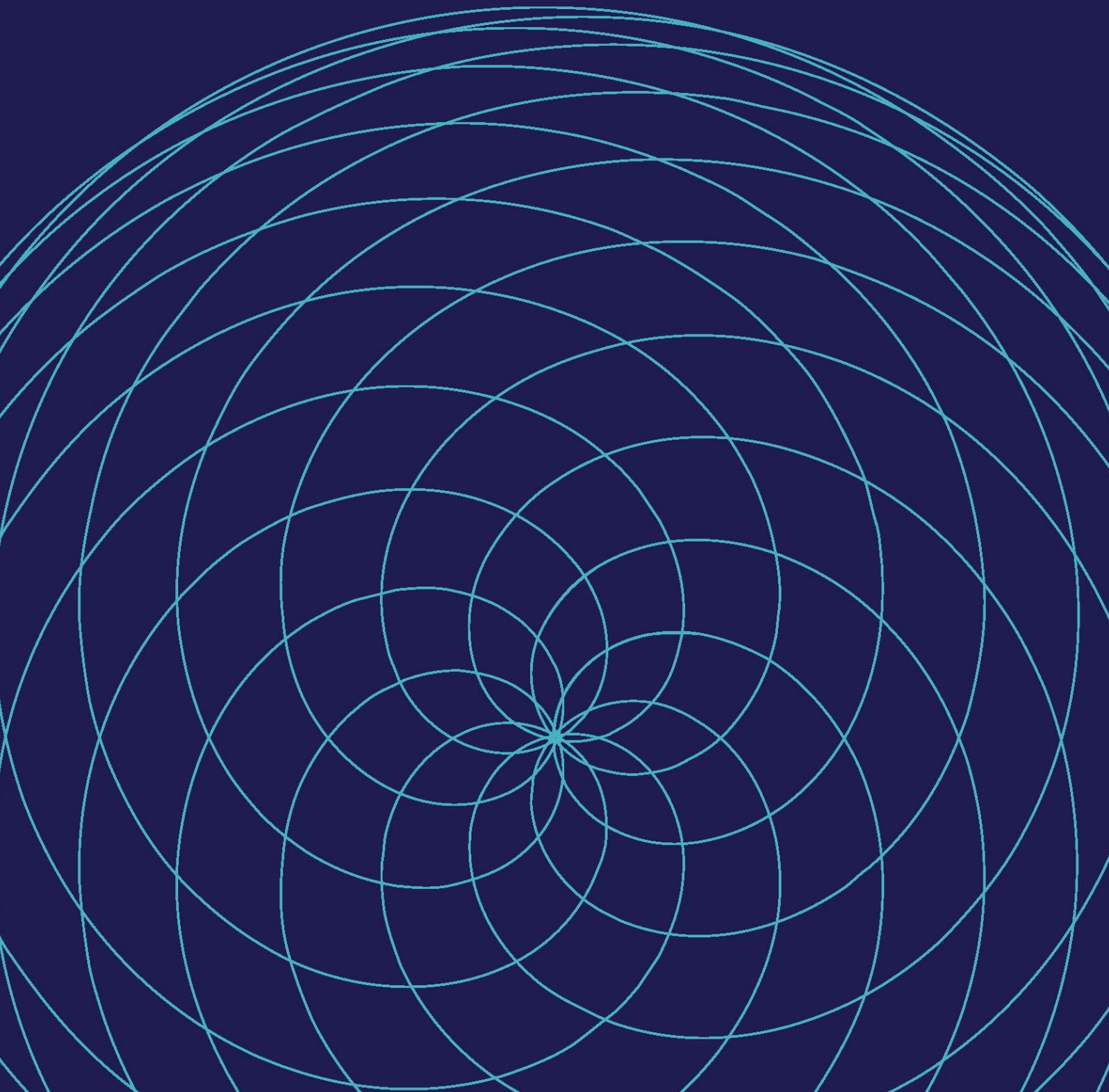
Your time commitment is likely to be considerable in the early stages, however, your role will tail off over time. Business and management skills will be needed for the spinning out as well as the running of the subsequent company. It is, therefore, important to identify these skills early on – usually in other people – enabling delegation of more of the day-to-day work of management, finance, sales and marketing to experts.

Occasionally, people choose to leave the University to concentrate full time on the business. If you intend to remain an employee of the University, you will need various consents from the University to participate in a spin-out (section 2). For example, employees generally do not take an executive directorship in a spin-out company, and some funding agencies (e.g., Wellcome Trust) do not allow researchers to be company directors.

There are legal responsibilities attached to being a director of a company (section 5.2) and before you spin-out you must understand these and decide whether the benefit outweighs the potential risk.

Involvement in the spin-out can also pull you in many different directions and can result in possible conflicts of interest, which must be appropriately managed (section 2.1).

## 2. Securing the University's support



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Once you have determined that forming a spin-out company is for you and the bare bones of a business plan are in place (section 3.2), you must concentrate on getting the University to buy into the project. This includes informing your Head of School of your spin-out plans at the earliest opportunity, as the company may require access to facilities and/or you may need to be released from some of your duties for a defined period of time.

As with any member of staff looking to form a company, you must submit your business plan for approval by the Company Formation Advisory Group (CFAG). ERI can advise and support you during each stage of this crucial process.

You will be asked to give a brief 'elevator pitch' to CFAG. The group gets together once a quarter to meet with potential spin-outs and provide constructive advice courtesy of key representatives of the University Court and the business community.

Your presentation will be excellent preparation for the great many business pitches you're likely to deliver once the process of seeking investment in the company begins.

The Head of School and all other relevant parties must sign off your business plan as confirmation that they're aware of the project and its implications (e.g., on your time/University facilities) and are in support of your plans in principle.

### 2.1. Conflicts of interest

If you wish to participate in a spin-out, you will need to consider the University's policy on holding external appointments and handling conflicts of interest since you may become a shareholder, director, and/or be seconded into the company. Approval from your Head of School will be required to actively participate in a spin-out.

The University has an established policy set out for dealing with issues related to '**Conflict of Interest**' (see Appendix).

## 2.2. University and founder-researcher equity

The University expects to be a significant shareholder in the spin-out company because of the resources and permission it makes available to the spin-out. Typically the University's shareholding will be equal to that of the academic founders.

The size of the shareholding agreeable to the University is dependent on a number of factors: for example, the roles of the individual researchers in the company; the IP; pre-company formation project-specific investment; and the involvement of the University in reaching the stage where a spin-out is possible.

Spin-out equity will also need to be shared between all those involved in the company such as the management team and (future) employees. This is a key issue that needs to be dealt with early in the process and can be partly addressed with a share option scheme (section 6.7) to reward future input. It will be important to future investors that the division of the company's equity (both current and any share options) appropriately recognises and rewards those people who are key to the strategic direction and growth of the company.

Inventors of the University-owned IP required by the company, who are active in the company formation process, can usually choose to take founding equity in the company **or** to share in the revenue received by the University in relation to the technology licence agreement (section 6.3).

HM Revenue & Customs (section 7.2) and the University view founding shares that are allocated for historical contributions as a benefit of your University employment. Therefore, if founders also received income from the technology licence agreement, as per the University's staff revenue sharing policy, they would be rewarded twice for the same activity (commonly known as 'double dipping'). As such, founder-researchers are asked to waive their right to receive income that may flow in the future under the technology licence agreement.

Founders are able to purchase shares in an arm's-length transaction alongside other investors without affecting their right to share in the University's future income.

It is typical for inventors who are actively participating in the company to take founding equity in the spin-out, while any inventors who are not actively participating usually share in the University's revenue.

Allocating founding equity in this way aligns with the expectations of investors who wish to see those critical to the company being rewarded through the success of the company (via an increased share price).

If the founding equity position is too heavily weighted in favour of historical contributions, investors are likely to 'correct' this (typically via the creation of a large option pool or via a company restructure). This type of 'correction' can negatively affect the equity position of other founders.

The key message is that it is best practice to allocate the founding equity carefully and ensure that the people needed for the future success of the spin-out are appropriately rewarded. ERI can advise you on this.

### 3. Pre-company formation – the action plan



# 3. Pre-company formation – the action plan

## 3.1. IP management

Before you do anything else you need to identify and protect your intellectual property because without IP most often there will be no company worth forming.

### 3.1.1. What is IP?

Intellectual property encompasses a range of different rights. Although a heavy emphasis is placed by spin-out companies and investors on patents, other kinds of IP can be just as useful.

The forms of IP most relevant to your purposes are likely to be:

- **Copyright** – for software, reports, online content
- **Design rights** – for equipment and engineering designs
- **Patents** – for inventions
- **Trade marks** – for names
- **Data** – to access, for example, clinical trial information not in the public domain
- **Know-how/trade secrets**

Your IP is likely to be one of your key assets; the people who can work that IP effectively are another. So it's crucial that you properly protect your IP. Although some rights are acquired automatically (e.g., copyright), you will have to apply for the appropriate registration to secure other forms of IP (e.g., patents).

The best way to protect your IP will be influenced by factors, such as the type of products and services the company will sell, your channels to market and the competitive advantage/increased profit margin provided by the IP.

It is worth bearing in mind that the patent process involves publication of the invention and therefore some companies choose instead to operate using trade secrets (e.g., Coca-Cola) and/or copyright (e.g., software based data analytics companies). Non-disclosure agreements with employees are an important protection used in businesses reliant on trade secrets.

### 3.1.2. A note on branding

Your name and branding can help you to stand out. When thinking about IP, also consider a memorable company name. It might be worthwhile registering your trading name as a trade mark, and you should certainly purchase any related website domain names that are currently available.

### 3.1.3. Due diligence

You need to identify all of the IP that the spin-out company will need by working through each stage of your development and production processes methodically to see what IP is required at each stage. The company may be reliant on a specific software package, manufacturing process, data set or technique for its success.

Write down every piece of IP that your investigations uncover – this list will be required for your discussions with ERI to ensure that the IP licence agreement transferring rights from the University into the company covers what your business needs to operate as a separate entity. It is also important to clarify to potential investors the IP rights that your business needs to operate successfully.

### 3.1.4. Freedom to operate

Under normal circumstances, and where an employee creates IP in the course of his or her day-to-day work, the ownership of the IP rests with the employer. Transfer of the right to use IP created within the University to a spin-out company will occur via an appropriate licence agreement (section 6.3).

It may be that other parties within the University, or further afield, have a stake in some of the IP that the company needs. Perhaps one of your doctoral students has made a contribution, resulting in 'joint IP' (held jointly between the University and the student). Or it may be that a third party working in a similar field already holds some of the rights that you'll require. For example, you may need to access the rights to a production/manufacturing process that is crucial to the development of your unique product.

To go ahead with a spin-out with confidence, find out exactly where you stand in this regard – otherwise your spin-out might risk infringement of third party IP rights.

You can search for existing patents and patent applications yourself using the European Patent Office's **Espacenet patent search website** (see Appendix). You should at the very least check for patent applications filed by other researchers and companies active in your field.

ERI can assist you with general queries about IP and the required IP due diligence. We run regular, free-of-charge IP surgeries and we work with a number of patent agents and lawyers who give their time free to answer initial questions. Generally, a specific piece of work will not be provided for free, however, independent IP advice can help to give investors comfort that the company has the required freedom to operate.

## 3.2. Business planning

At the same time as conducting due diligence and protecting IP, you need to scope out the company's offer and how it will operate. You won't get your business plan right first time; it's an evolving process, and one in which ERI can lend a hand.

Among the questions we'll consider together are:

- **What will the company do? Specifically, what products or services will it sell?**
- **What is your business model? How will you get products and services to your customers – directly or via 'agents'?**
- **Which target markets will you aim for?**
- **How will the company differ from its competitors? What's its unique selling point? What benefits are afforded by the IP?**
- **What IP must you transfer from the University to the spin-out? And what kind of licence will you seek?**
- **What's the likely timescale between completion of research and going to market?**
- **What funding will the company require and where will it come from?**
- **Are specialist facilities required?**
- **Who will be involved in the day-to-day management of the company?**

Putting your ideas down on paper isn't only essential in demonstrating the company's viability and your commitment to potential investors; it also serves as a very valuable exercise in simply getting things straight in your own head.

Additionally, any organisation with IP to which the company needs access (be it the University or a third party) will want to see the business plan for reassurance that the likelihood of the company using the IP to good effect is promising.

### 3.2.1. What goes in the business plan?

- **Executive summary** – a high-level overview to inspire the investor to find out more
- **Background** – brief details of what you've done so far, focusing on your research and the resulting IP
- **Business offer** – details of the company's products/services and marketing/sales approach
- **Market** – a discussion of the current market, market drivers, how the IP fits into the supply chain, and how the company will differentiate itself from any competition that exists
- **Staff** – a description of what each of the key people brings to the business, plus any plans to recruit further managers
- **Risk analysis** – set out your ideal scenario and also how you'll manage should the worst happen
- **Financial information** – financial projections for at least three years, to cover cash flow, balance sheet and profit and loss account

Investors will be particularly interested in scrutinising the figures. They will be seeking assurances that they'll see a return on their investment, and that this will be within an appropriate time frame.

You're likely to be asked what the company will do should things go wrong, milestones be missed or funding run out. If you've already rehearsed answers to these and any other difficult questions likely to arise, you'll be in a better position to respond effectively.

### 3.3. Market research

A big part of what ERI does is to help independently qualify the value of an innovation to properly ascertain its commercial strengths and weaknesses.

ERI has access to many successful entrepreneurs – some of whom have sought our support in the past. We have also established a wider network of industry contacts by virtue of the volume of licence and co-development projects we undertake. Through these connections we have a broad range of real world business expertise and mentors at our disposal.

When you come to us with your idea, we will help you to reach out to an early adopter for an impartial perspective on its chances of success and to pin down the business opportunity to focus the company's efforts on the best route to market. Sometimes the initial market isn't obvious, particularly when it is beyond the originator's field of research. Further, in-depth, independent market research may be commissioned following this preliminary stage. ERI has access to funds to support this.

### 3.4. Building your team

You may already have people in mind for some roles within the company – but make sure that selections are made for the right reasons. You'll require different skills of your colleagues when running a business compared to those you require in a research setting.

It can often make sense to recruit people from outside who are already expert in their own particular area or can open doors to key contacts and markets. In the course of building the proposition you'll attend numerous trade shows, business meetings with potential customers/collaborators and pitch to a range of interested parties. This will give you some insight into the strengths and weaknesses of the current team. The make-up of the company will change as the business grows and it becomes necessary to have other skills at management level.

Be sure that any research associates intending to move to the company are able to fill some of the identified skills gaps. Prioritise their appointments early on to maintain enthusiasm and prevent commitment waning, and be clear that they are part of the founding team and will be fairly incentivised.

Making prompt professional appointments can help at this stage – for example, appropriate legal counsel and tax advisers to assist with incorporation issues and licensing (section 6).

## 3.5. Funding

Taking your idea to market, and operating and growing a business, will require a – considerable, in some cases – injection of cash. Be realistic in the business plan about exactly what's needed; underestimating the funding required will just cause setbacks later.

Funding might come from any or all of the following:

- **Business angels**
- **Venture capitalists**
- **Corporate venturing**
- **Bank loans**
- **Grants**

All of these sources of finance want something in return, for example, interest, equity or products. ERI can both advise on the advantages and disadvantages of each source and help to put your idea in front of potential investors, supporting you throughout the process of securing their backing. As we add to our successes each year, we broaden the range of investors keen to work with us.

Investment can, of course, mean more than simply providing access to funding. It can be hugely advantageous to your business if an investor is able to share contacts or other resources that could benefit the company. And once one name has invested in the company, it will be much easier to attract further interest.

### 3.5.1. Business angels

High net worth individuals keen to invest can be located through *LINC Scotland* and the *UK Business Angels Association* (see Appendix). Both are home to successful business people and entrepreneurs who may be prepared to back a new spin-out company. There's considerable financial risk involved for the business angel, so a significant shareholding in the company will be expected in return.

Given that business angels tend to have interests in more than one venture, they are unlikely to want to be heavily involved in the day-to-day running of the company, which may be preferable.

### 3.5.2. Venture capitalists

Venture capitalists specialise in providing 'risk' finance. It's all that they do, so they generally have a pretty clear idea of the kind of set-up they might invest in and those they definitely won't. Some venture capitalists will only look at your company if it operates in a particular sector or has already reached a key growth stage.

Often the finance to be invested will be provided on the achievement of agreed milestones. If these tasks are not completed satisfactorily, then further funding will likely be withheld. This serves as a useful way for the venture capitalist to guard against complacency and protect against throwing good money after bad.

As they are putting in hard cash, venture capitalists – and business angels – will be keen to see you put in some cash too. This gives investors the additional confidence that you are fully committed to the venture and do not see it merely as an extension of your research activities.

Investors will also be keen for all of your reward to come directly from increasing the value of your shares; for this reason they will not support you in receiving significant (if any) consulting fees.

### **3.5.3. How to pitch to potential investors**

Before writing your business pitch, consider the specific investor you have in mind and what are their likely preferences and concerns around providing funding.

Make sure that you write a business pitch that inspires confidence and assuages any concerns. The focus is not on the innovation itself. It is all about the product or service that the company is going to take to market and what it is about that product that will inspire people to buy it – not just once but repeatedly, and in ever greater volumes.

The pitch should be accompanied by a formal slide presentation using clear schematics to explain business models, product lines, routes to market, and development and purchasing cycles.

The presentation should cover:

- **Key details about the company team and the presenters' roles**
- **The products and/or services**
- **Target market, including data on growth and trends**
- **The company's competitive advantages**
- **The business model – how the company will reach and sell to the end user**
- **Timescales and milestones along the way**
- **Any key issues to address before spinning out the company**

### **3.5.4. Future investment**

Ongoing investment will be important as the company will need access to cash at every stage. Over time, the company is likely to move away from risk finance towards debt finance and/or income from sales.

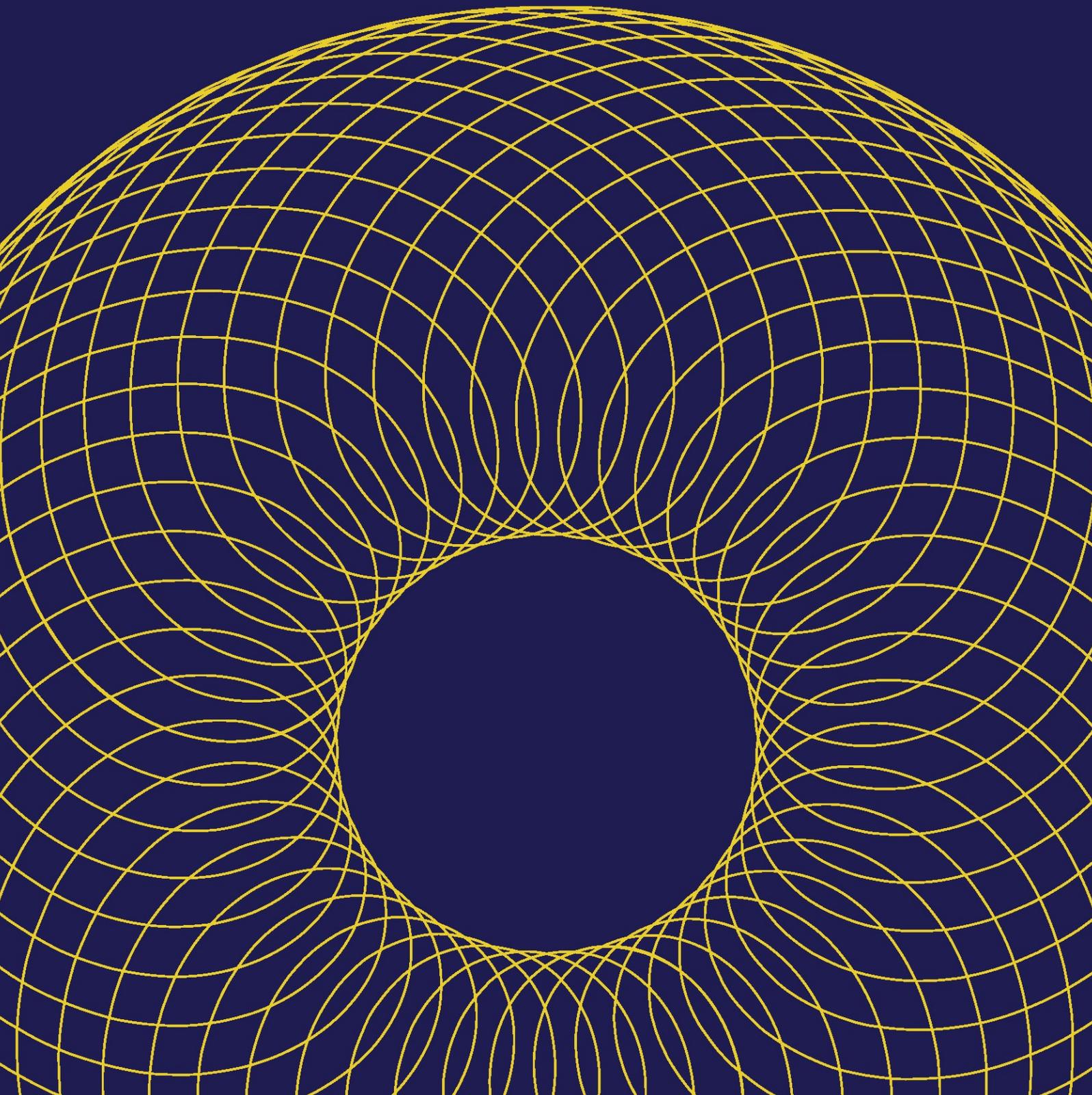
Securing grants that support product diversification (e.g., SMART) and enable collaboration (e.g., KTP and TSB awards) is a good way to part-fund further developments. It is, however, important to use grant funding to complement the development of the core product rather than distract attention down new avenues before the company is ready.

### **3.5.5. Exit strategies**

Somewhere down the line, investors will wish to recoup their investments. The company will have to be sufficiently stable to allow this.

When pitching to and accepting cash from investors, the company should take account of any time sensitivities they have. Try to ensure that the investor's timeline aligns with the company's ability to increase in value and its potential to be in a good position for the shareholders to benefit from an exit.

## 4. Establishing the company



# 4. Establishing the company

Setting up a company involves a number of actions, the most immediate of which are:

- **Incorporation of company** – decide on registered office, directors, company secretary, shareholdings of founders
- **Register for VAT** – VAT must be charged by the University of Edinburgh for the consideration paid for the IP, including when that payment is partly satisfied by the grant of shares
- **Open business bank account**
- **Obtain venture capitalist/seed/corporate/grant funding**

This stage will involve a lot of advisers, including business mentors, legal advisers, tax specialists and patent attorneys (where relevant). Each has an important role to play in covering all of the bases.

## 4.1. How long does it all take?

It's impossible to set a hard-and-fast timeline for spinning out a company from the University.

That said, around six to nine months, from the first thorough draft of the business plan to agreeing a licence, is fairly standard.

Delays most commonly result from difficulties in securing finance. There is precious little point in signing a licence before funding is in place – without money the company can't do anything with the IP because it can't pay for premises, staff, patent costs or consumables.

## 4.2. Company constitution

The company is most likely to take the form of a private company limited by shares. A company is a legal entity in its own right and can enter into contracts and undertake obligations.

The ownership of the company rests in the hands of its shareholders. Some may have a controlling stake in the company, others not. Either way, it is the directors who manage the company day-to-day, and they may or may not be different people to the shareholders.

Directors tend to take a strategic role but in a small company will likely participate in the day-to-day management too. The shareholders are ultimately in control as they can veto decisions and recruit or remove directors.

#### **4.2.1. Shares**

Different rights can attach to different sorts of shares, with ordinary shares being the most basic form. Keeping things straightforward and easily manageable is crucial at the start.

In the future, investors may demand shares with preferential rights in return for their funding support: for example, a class of preferred ordinary shares may be issued with rights to a preferred dividend or enhanced voting rights. Be sure that any decision to award shares to anyone outside the company is only made after first seeking legal advice and because you are certain that making such a move is in the interests of successfully growing the company.

#### **4.2.2. Liability**

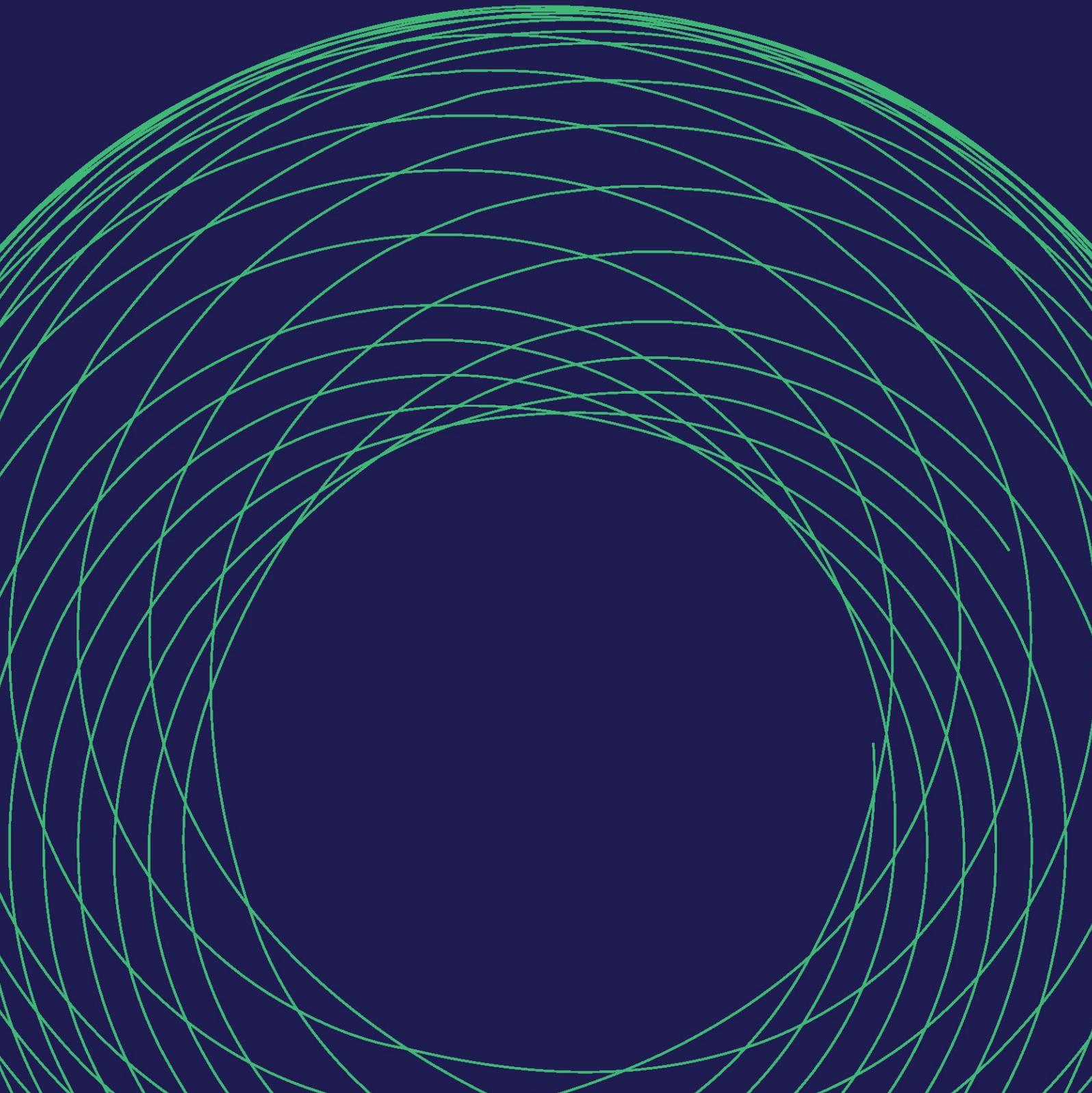
As the company will likely be a private company limited by shares, the liability of shareholders if things go wrong will be limited to the amount, if any, unpaid on his or her shares – in other words, the capital they hold in the company.

Personal assets should not be at risk if the company gets into debt or is sued, except where a shareholder has agreed to take on a personal liability for the company.

Directors can sometimes be held personally liable for what goes on in the company, for example, if they recklessly run up debts that won't ever be repaid or otherwise act wrongfully such as failing to act if the company is headed towards insolvency. In such instances, a director might incur financial penalties, be temporarily relieved of any directorships, may have to contribute to the reimbursement of the company's creditors or may even receive a criminal conviction.

If you plan to become a director of the company, it is prudent to invest in directors' liability insurance to protect your personal wealth.

# 5. Role of shareholders and directors



# 5. Role of shareholders and directors

## 5.1. Shareholder

As a private company limited by shares, ownership rests with the shareholders, who control the company by their ability to appoint and remove directors. The vast majority of powers relating to the day-to-day running of the business do however lie with the directors. The directors also have certain duties or responsibilities to protect the company's best interests.

Shareholders exercise their voting rights via the passing of ordinary or special shareholder resolutions:

- **Ordinary resolution – passed by shareholders who hold more than 50% of the voting shares**
- **Special resolution – passed by the holders of at least 75% of the voting shares and required for certain key matters**

Shareholders also have it in their powers to:

- **Vote at general meetings**
- **Alter the Articles of Association (which govern how the company is run internally and set out the rights that attach to the shares)**
- **Give directors permission to allocate shares – whether to existing or new shareholders**
- **Revise the company's share capital**
- **Elect new directors and remove existing directors.**

In addition, some shareholders may receive a portion of the company's profits in the form of a dividend, normally given on an annual basis.

More often than not, by the time the company is a profitable concern, the shareholders' goal – particularly in venture capitalist or business angel backed companies – will be to sell it for a substantial capital gain rather than siphon off smaller annual dividends.

## 5.2. Directors

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.

Together, the directors form the board of the company, which leads the strategic direction of the company. The board will meet regularly to review the company's finances, ability to meet its obligations, objectives and responsibilities. Crucial decisions about how the company is managed are generally made by a vote. The chairman of the board will have the casting vote in the event that there is no majority.

If you become a director of the company, you will need to file personal details such as your address and specifics of any other directorships (past or present) on a public register at **Companies House** (see Appendix).

### 5.2.1. Shadow director

Even if you're not officially a director, you may nevertheless advise the board as though you were one and the board may tend to follow your advice. In such cases, you could be considered a 'shadow director', which brings with it the same liabilities and obligations as a director who is officially appointed as such. Make sure that you know where you stand.

A distinction is also made between executive and non-executive directors of the company.

### 5.2.2. Executive vs. non-executive

Executive directors have a specific role such as chief executive, finance director or sales director, although their involvement at board meetings spans the full array of company matters.

A non-executive director, in contrast, is a generalist chosen to augment the skills of the board. Often an investor will stipulate that at least one non-executive with extensive business expertise is appointed.

A non-executive chairman of the board will generally be chosen to complement the chief executive and ensure a well-rounded view.

Otherwise, the powers of executive and non-executive directors are much the same. For the avoidance of doubt, these are set out in the company's Articles of Association.

All directors are expected to adopt an approach of active and diligent participation. It is important that the whole board is involved in decision-making processes in order to arrive at sensible and appropriate judgements that draw on all of the available expertise.

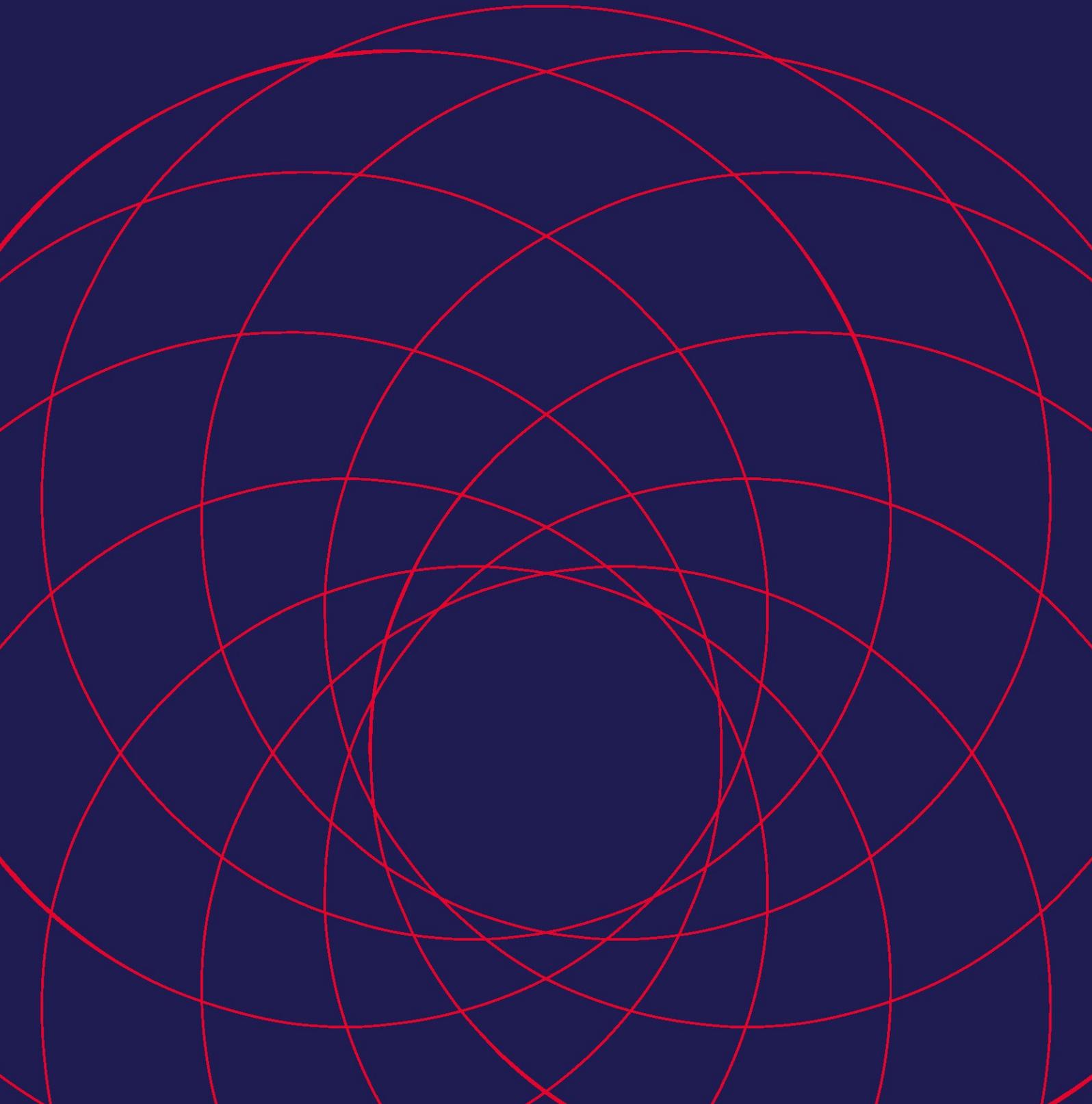
Directors have duties to:

- **Exercise independent judgement**
- **Operate with reasonable care, skill and diligence**
- **Avoid conflicts of interest**
- **Refuse benefits from third parties**
- **Declare any interest in proposed transactions or arrangements**
- **Promote the success of the company**
- **Act within their powers**

Directors must always consider the bigger picture, paying particular attention to:

- **Employees' best interests**
- **Customer and supplier relationships**
- **Commercial reputation**
- **Community engagement**
- **Environmental responsibility**
- **Fairness in dealings with everyone in the company**
- **Long-term impact of strategies adopted**
- **Corporate governance, for example, holding regular board meetings and issuing company information to shareholders**

## 6. Company documentation



# 6. Company documentation

Setting up a new spin-out company involves a lot of paperwork and it's important to do everything by the book.

The company documentation is important to suitably protect the business and its investors.

## 6.1. Articles of Association

This document sets out the basic management and administrative structure of the company and establishes the different rights held by ordinary and other classes of shareholder. Investors may subscribe to different types of shares to the management team and may have preferential rights such as greater voting rights or the right to collect dividends.

The Articles regulate the internal affairs of the Company, such as the issue and transfer of shares, board meetings, shareholders' meetings borrowing powers, etc.

Shareholders' powers to recruit and dismiss directors, and the powers of executive and non-executive directors themselves, are detailed in the Articles. The Articles should deal appropriately with good and bad leavers, which can be especially important in the early stages of the spin-out.

Shareholders generally frown upon the transfer of shares in the company. It's likely that they'll be keen to stipulate certain restrictions in this regard in the Articles. It is typical to distinguish between permitted transfers and compulsory transfers, and perhaps also provide for exit strategies in the Articles.

Any spin-out from the University of Edinburgh will include in its Articles details of the rights pertaining to the University. These generally include:

- **At a minimum, observer status on the board and the right to appoint a director;**
- **Right to receive board papers and other relevant shareholder information such as the management accounts and written details of any offer to buy the Company;**
- **Right for the University to transfer its shares within the University group; and**
- **Standard pre-emption rights, and appropriate 'drag along' and 'tag along' exit provisions.**

ERI is able to provide template Articles, which meet these requirements and may help to get the company started. However, the company will inevitably need to take its own legal advice.

## 6.2. Shareholders' Agreement

Generally, a Shareholders' Agreement sets out the terms by which the shareholders invest in the company, both in respect of the number and price of shares purchased and also the company's obligations to the shareholder. It is, therefore, usually only put in place at the time of external investment (companies typically rely on the Articles of Association until this time).

Every shareholder must, for instance, receive regular financial and management reports in order that they may scrutinise the progress of the company. This information might include monthly accounts reports and board minutes.

The Agreement will also cover any rights shareholders have to appoint either an investor director as their representative at board level or to nominate an observer to attend board meetings on their behalf.

### 6.2.1. Restrictive covenants

Shareholders will wish to see in the Agreement a list of actions that the company – and sometimes also key personnel – agree to refrain from without first securing their consent. These are known as Restricted Acts and protect against the company taking on excessive borrowings or appointing an alternative auditor, for example.

Additionally, it is fairly common to restrict key personnel from working with and/or setting up a competing company, usually for an agreed period of time. It is important to take independent advice regarding any restrictions that you personally agree.

Although the motivation of a Restrictive Act – in the context of those who remain University employees – is well founded in its aim of preventing conflicts of interest between company and University activities, it may inadvertently affect your research activities and career. It is, therefore, important to take advice before entering into any such agreements.

### 6.2.2. Warranties

Any warranties made by the directors will be included in the Shareholders' Agreement. These are not generally a key issue at the spin-out stage, but you must remember that making any form of warranty could leave you open to financial and criminal liabilities. Company founders and directors must be quite certain of any facts that they warrant, and must also be sure to disclose all relevant information to investors in order to mitigate this risk.

The Shareholders' Agreement will evolve in line with the company and in particular when new investors become involved.

## 6.3. Technology licence agreement

This will authorise the company to use any specified IP owned by the University that the company wishes to use and which the University is able to make available.

The technology licence will not be free of licence fees and royalties partly because, as a charitable organisation in receipt of public funding, the University has an obligation to act in an arm's-length way that encourages exploitation of the technology for the public good. That said, the licence terms will be sympathetic to the circumstances of the new company due to the importance of cash in the early years of a spin-out's life.

In addition, because part of the licence consideration will be satisfied by issuing shares to the University, the University will require some standard shareholder protections to protect its position as a (usually minority) shareholder in the Company. Generally in the initial stages, the University's consent will be required before the Company can:

- **Issue shares, or options to acquire shares, in the company (other than those agreed in the share option scheme) in a non-arm's length way. In other words, the company would be free to take in third party investment at an arm's-length share price without reference to the University**
- **Create or acquire subsidiaries**
- **Diverge to a material extent from the business plan**

## 6.4. Premises

The company will need somewhere to operate the business from. ERI's incubation centre, *Edinburgh Technology Transfer Centre* (see Appendix), provides a safe space where spin-outs can develop their business model in the early years and also benefit from being close to a community of entrepreneurs in the same situation.

ERI can also offer more established companies value for money premises in our science and technology parks.

## 6.5. Secondment

It is likely that the company and its investors will want to secure access to the services of the founding researchers. The arrangements between those individuals employed by the University and the company will need to be approved by the relevant Head of School.

Arrangements should be documented in a secondment agreement and the secondee will be expected to maintain a separation between University and company duties.

Typically, under a secondment agreement, the company pays the University for an agreed proportion of the secondee's time and the secondee continues to receive his or her basic University salary. The secondee's input to the company is, therefore, rewarded by shares or an option scheme, as agreed within the company.

## **6.6. Employment contracts**

The company must make certain that any new IP generated by its employees/consultants remains the property of the company. Non-disclosure agreements and suitably watertight employment contracts should be put in place, and the use of independent consultants carefully managed.

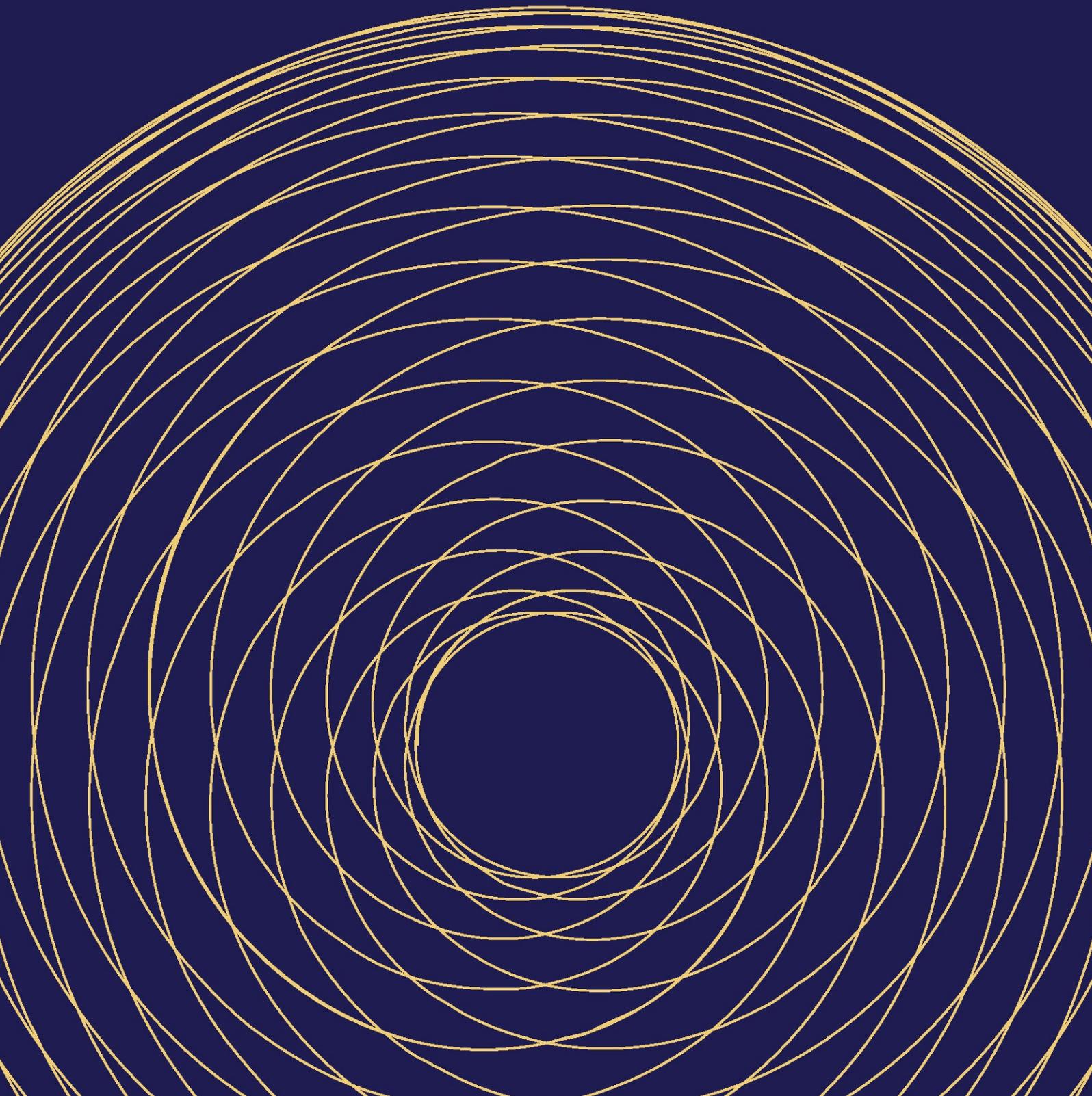
## **6.7. Share option scheme**

All spin-out companies are likely to establish an incentive scheme at some stage.

A share option granted to an employee will give the employee the right at a future date to acquire a specific number of shares in the company. This may be upon the occurrence of a certain event, e.g., exit, time served or performance. This has the advantage of incentivising the employee without immediately giving away equity.

Certain types of share option can be particularly tax efficient and there can be advantages to setting up the scheme at the spin-out stage.

# 7. Tax matters



# 7. Tax matters

Don't make the mistake of only considering tax issues as an afterthought. Setting up a spin-out company can affect your personal tax liability in several ways.

## 7.1. Enterprise Investment Scheme and Entrepreneurs' Relief

Tax breaks offered to higher risk, small companies may also help to attract investors, particularly if it's business angel funding that you seek. Explore how the UK Government's **Enterprise Investment Scheme** (see Appendix) could help the company – and you, if you're also investing in the company.

Additionally, **Entrepreneurs' Relief** (see Appendix) may enable you and other shareholders to claim some relief from capital gains tax upon disposal of shares.

You should also seek specialist tax advice to be certain of your position – and also that of the company.

## 7.2. Income tax

You may be required to pay income tax on any shares you acquire in the spin-out company – but only if you pay less than the market value for them. In such instances, HMRC will deem the shares to be a taxable benefit of your employment. It makes no difference whether it's the University or the company that is considered your employer here. The outcome will be the same. If you will be contributing cash and/or assets to the company, you should ensure that these are used as payment for shares.

Your income tax liability in respect of the shares may be greater where assets and cash have been injected into the company, e.g., by the University or an investor.

Your situation may be more complicated if you hold 'restricted shares' in the company. For example, a compulsory transfer arrangement may restrict your ability to retain the shares if you leave.

The effect of 'restrictive share' legislation is to increase the tax levied on the 'gain' to align with income tax rather than capital gains tax. You should seek specific legal advice before accepting restricted shares.

If you are not a shareholder and, instead, receive a proportion of the University's revenue as reward, such income payments will be subject to income tax and National Insurance Contribution (NIC) deductions.

## 7.3. Corporation tax

As a separate legal entity, the company will have its own tax liability. Corporation tax for the company's accounting period is calculated annually by means of a self-assessment tax return.

The company is unlikely to pay much, if any, corporation tax in the first few years of trading as turnover probably won't surpass the allowable expenses for quite some time.

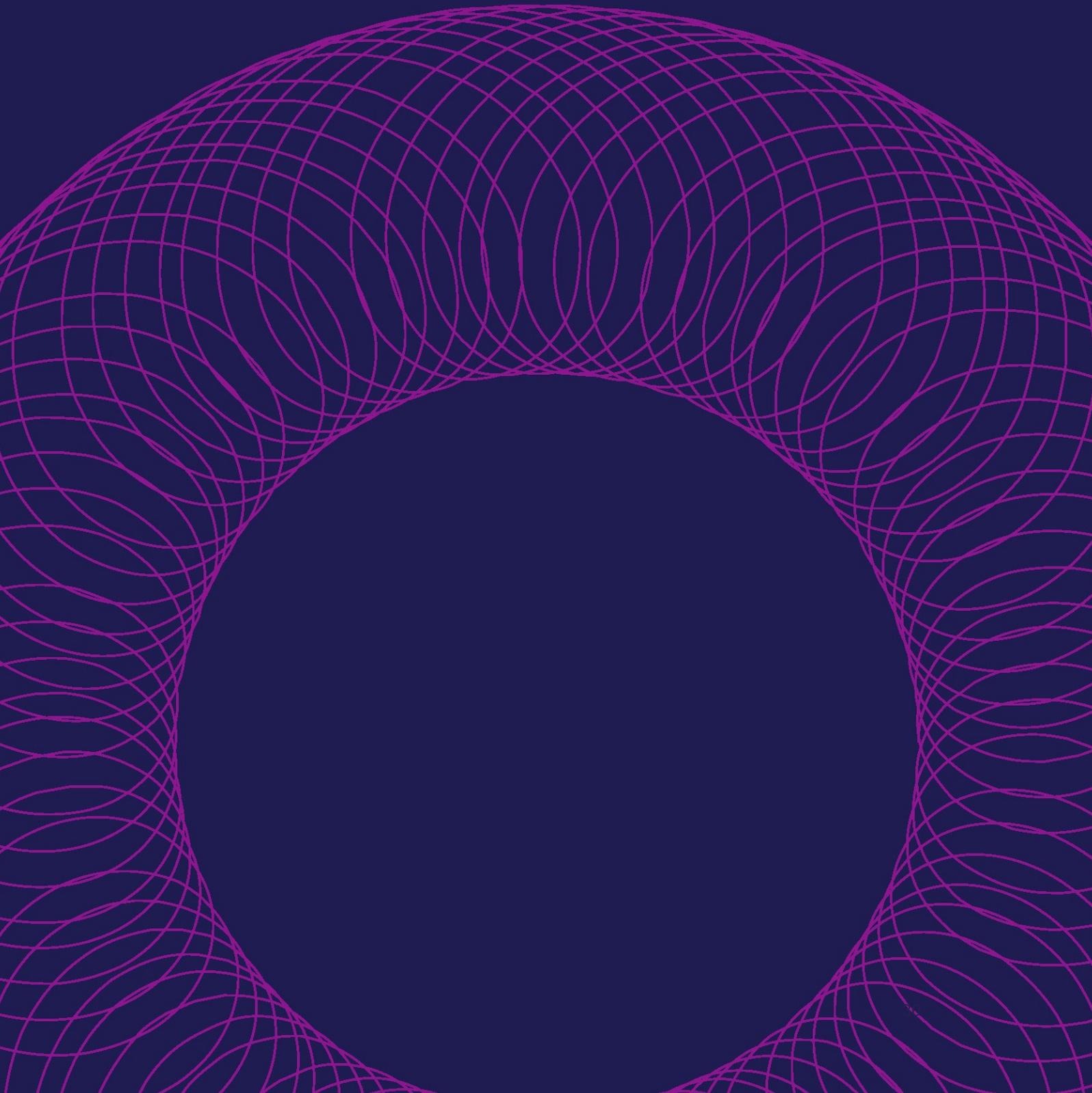
The situation needs to be carefully monitored and future tax payments budgeted appropriately. Once tax losses turn into profits, the company will become liable for corporation tax.

It's worth seeing if the company qualifies for **Research and development tax credits** (see Appendix).

Your company must also deal with PAYE and NIC commitments and VAT.

Employing an accountant, and possibly a bookkeeper too, can help the company to maintain the meticulous accounts and tax records that are so crucial for auditing and compliance purposes.

# 8. Insurance



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## 8.1. Individual insurance

When you are involved in setting up a business and, particularly, if you serve as a director – or even as a ‘shadow director’ – you leave yourself open to significant personal financial risk from claims made against the directors in relation to their duties.

To protect yourself, your family and your personal wealth, it’s worth sourcing a quality directors’ or officers’ liability insurance policy to protect yourself in respect of claims from which the company does not indemnify you. Your legal counsel should inspect any such cover carefully to ensure that it guards you sufficiently against the specific risks that you face.

You cannot protect yourself against criminal liability; you and your fellow board members must ensure that conduct within the company always remains above reproach.

## 8.2. Company insurance

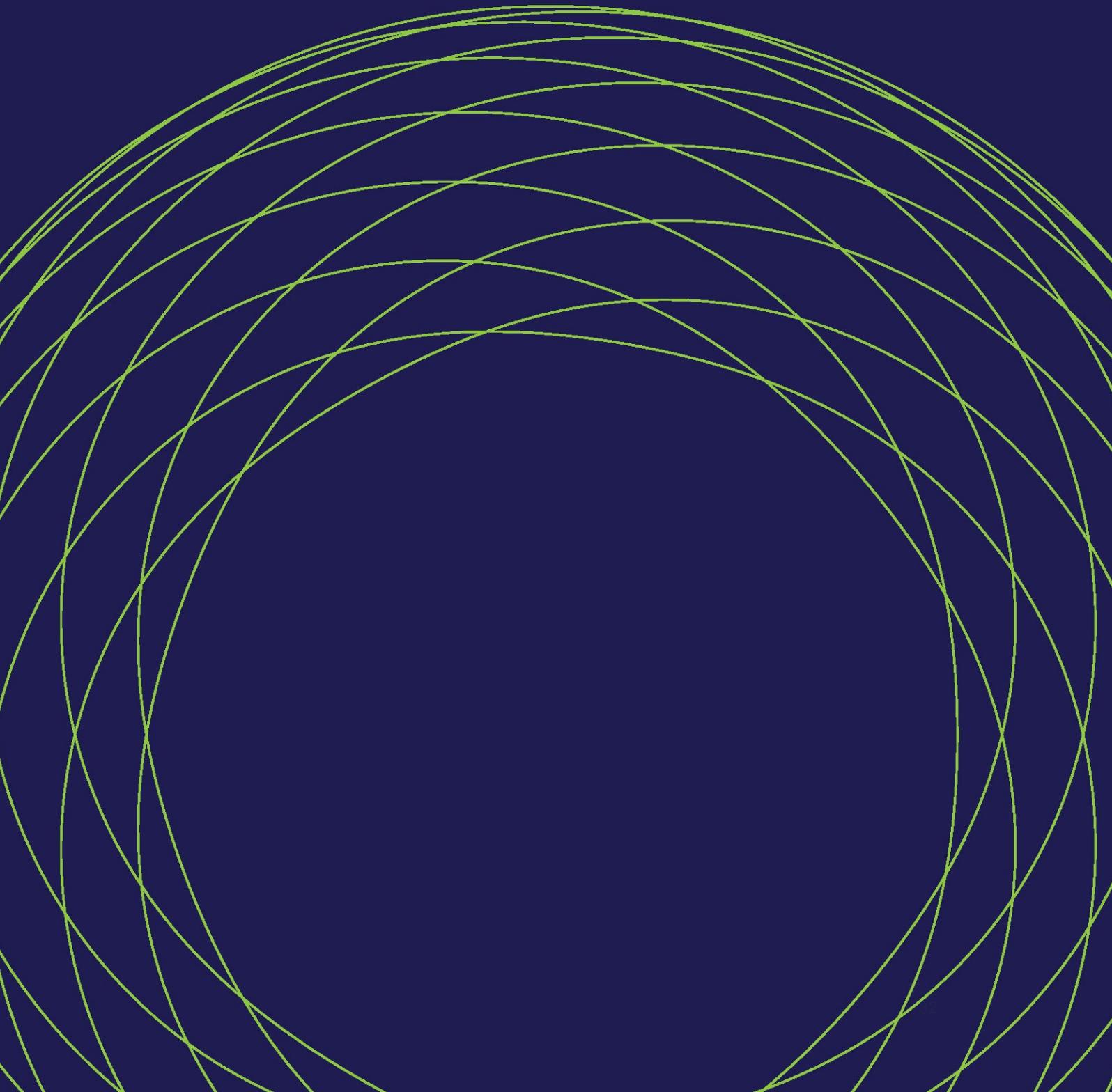
It is likely that the company will rely on a number of key people across the company. Taking out ‘keyman’ insurance for such colleagues will protect the company from the costs associated with their illness, incapacity or death. The company’s investors may even insist upon it.

Employers’ liability insurance is one of a number of compulsory insurances that will certainly apply to the company. It might also be prudent or necessary to cover yourself against such things as public and product liability, and material damage.

Pinpoint where the company is exposed to liability and other risks, and seek appropriate professional advice.

As with all aspects of establishing a spin-out company, you can’t know exactly what’s around the corner. But you can make some educated guesses and protect yourself against the worst negative outcomes.

## 9. What happens next?



# 9. What happens next?

More information can be obtained by contacting Edinburgh Research and Innovation:

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Kings Buildings  
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Edinburgh  
EH9 3JL

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Email:           [Tom.Ogilvie@ed.ac.uk](mailto:Tom.Ogilvie@ed.ac.uk)

# Appendix

## Useful links

### ***Conflict of Interest***

University Policy on 'Conflict of Interest'

[http://www.docs.csg.ed.ac.uk/HumanResources/Policies/Conflict\\_of\\_Interest.pdf](http://www.docs.csg.ed.ac.uk/HumanResources/Policies/Conflict_of_Interest.pdf)

### ***IP management***

European Patent Office Espacenet

<http://www.epo.org/searching/free/espacenet.html>

### ***Funding***

LINC Scotland

<http://www.lincscot.co.uk>

UK Business Angels Association

<http://www.ukbusinessangelsassociation.org.uk>

### ***Directors***

Companies House

<http://www.companieshouse.gov.uk>

### ***Incubation Centre***

Edinburgh Technology Transfer Centre

<http://www.etc.co.uk>

### ***Tax matters***

Enterprise Investment Scheme (EIS)

<http://www.hmrc.gov.uk/eis/>

***Tax matters (continued)***

Entrepreneurs' Relief (for business assets)

<https://www.gov.uk/entrepreneurs-relief>

<http://www.hmrc.gov.uk/cgt/businesses/reliefs.htm>

Research and development tax credits

<http://www.hmrc.gov.uk/ct/forms-rates/claims/randd.htm>

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