Lifting off, the offshore way – a guide for founders and start-ups to offshore companies

At Harneys, we are often approached by the founders of start-ups, their investors and their onshore advisors looking for a steer on whether (and where) to incorporate, or looking for advice on raising funds. In this article, we have sought to cover some of the questions we are most often asked, and to break down the key elements of offshore structuring.

We advise companies at all stages of their development, and have taken clients from first incorporation, through substantial investment, to IPO and beyond.

In this article, we will focus on the BVI and Cayman, which are the most popular offshore jurisdictions for start-ups, although Harneys also advises start-ups on the laws of Anguilla, Luxembourg, Cyprus, Bermuda and Jersey.

Why go offshore?

One of the first stages in any start-up's journey is setting up their legal entity. Establishing an entity conveys a certain level of legitimacy and professionalism but, more importantly, until you do the founders are personally liable for all the debts of the business.

Many of our clients come to us having already incorporated a company and picked a jurisdiction, but for those that have not, we are often asked to give a steer as to where might be the best home for their business.

Whether it is appropriate to go offshore will depend on where your main business will be carried out, where your investors will be and where the company will be managed from. There are several general advantages of offshore vehicles, which are common to both BVI and Cayman:

1. Tax neutrality – no corporate taxes, taxes on capital gains or withholding, and no stamp duty, except in limited scenarios.
2. Flexible and modern corporate laws – because of the importance of the financial and legal sectors in the BVI & Cayman, it is important to both jurisdictions that corporate legislation is adaptable to, and stays up-to-date with, the ever-changing demands of global business.
3. Sophisticated service providers – as well as lawyers, both jurisdictions are home to a wide range of business service professionals (trust companies, fund managers, accountants) who are used to dealing with the requirements of international businesses and are familiar with a broad range of sectors as well as dealing with new trends in the market.
4. Independent and respected judiciary – despite their size, both BVI and Cayman are used to seeing some of the largest value litigation in the world which means invaluable experience and knowledge within the jurisdictions. Our courts also allow for appeals to the Privy Council (the same judges who sit on the UK Supreme Court).

Although the jurisdictions share much in common, there are some differences in general terms, it is fair to say that the BVI tends to end up somewhat more cost effective, and in some respects has additional flexibility. Cayman, however, benefits from being the most popular choice for publicly listed offshore companies, and is well-known to private equity investors who often use such vehicles for their own structuring.

Choice of vehicle

Both the BVI and Cayman provide various options when it comes to the choice of legal vehicle and which model is appropriate will depend on a client's needs.

In the BVI, while companies limited by shares are by far the most popular vehicles, BVI trusts[1] and partnerships are also increasing in popularity and may be considered as alternatives depending on the client's needs.

Similarly, in Cayman, exempted companies are the most commonly used vehicles but other vehicles are also available, including 'US style' LLCs. The Cayman foundation is currently a popular means for providing a "legal wrapper" to decentralised autonomous organisations (DAOs)[2].

The "standard" company structure will be the one suitable for most start-ups – it provides for the benefit of limited liability, separates ownership (shareholders) from management (directors), and through the issuance and transfer of shares, is a simple structure in which to bring in new investors.

Bringing in money – debt v equity v …tokens?

Traditionally, the most common means for companies to raise capital in the BVI and Cayman (and in the rest of the world) is through debt or equity.

In the simplest terms, debt finance involves a party providing money to a company with the expectation it will be repaid (usually, with some element of interest). This loan may come from its shareholders, a bank, or other third party lenders. The biggest advantage of debt finance from the company's perspective is that it usually means that the equity of the company remains protected from dilution, allowing the founders to retain ownership as the company grows. Lenders do not usually get a direct say over management of the company, but it may place restrictions on the company, whether that be security over assets or limitations on what the company can or cannot do, in order to protect their investment. A lender is typically entitled to be paid back the amount they advanced plus some level of interest regardless of the performance of the company (so debt can lead to cash flow issues or even insolvency) but does not get a share of profits. Although the loan documents may include covenants preventing the company from doing certain things without lender consent, a lender does not usually get voting rights.

Bringing in money through equity, on the other hand, means giving up a proportion of the ownership of the company (usually through the sale of shares) in exchange for funds the company can use for its operations. This will inevitably mean some dilution of founder equity in the company and, potentially, with it the sacrificing of future sale proceeds, corporate profits, and/or an element of control. However, it may be necessary to take this approach during the early stages of a business' growth if it is not possible to secure lending because of the lack of historic financial success and identifiable value in its assets which a lender can secure their interest against. Taking equity finance also has some big advantages over debt – it does not have to be repaid within a specific period (or, indeed, at all, if the company never becomes profitable) and it does not sit on the balance sheet as a liability.

In theory, there are big differences between the two, but in practice, it can be more nuanced. There are various types of hybrid options, such as debt convertible to shares, or preferred shares with a fixed return that looks similar to interest. There are even profit participating notes that do not get paid unless the company makes a profit.

At Harneys, we are also used to dealing with the less traditional means of raising funds. For example, in recent years we have had a lot of experience advising on the use of special purpose acquisition companies (SPACs)[3] and the de-SPAC process that involves the acquisition and investment in and taking public of high value private companies. Similarly, we have seen a rapid growth of our crypto practice[4] and are used to advising on token issuances as a means for companies to raise investment.

As discussed above, each form of funding comes with its own risks and rewards and deciding which approach is best for the company and its founders will often depend on various considerations. For example, the willingness of the founders to sacrifice a proportion of their ownership to another party versus the availability of, or lack thereof, leverage in the company's growth potential to convince someone to lend.

Depending on where a company is in its growth cycle will affect the options that are available to a company in terms of fundraising. Most start-ups go through many rounds or series of fundraising, and there are professional investors who specialise in each of these.

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1 https://www.harneys.com/insights/bvi-trusts-purpose-trusts/

[2] https://www.harneys.com/insights/daos-a-note-of-caution/

[3] https://www.harneys.com/insights/a-snapshot-on-spacs/

[4] https://www.harneys.com/expertise/investment-funds/blockchain-digital-assets/

Structuring ownership

It is critical that founders have a vision for how the business should be owned and how that ownership should be regulated as it progresses.

Getting shareholdings right at the start is incredibly important as it can help avoid issues down the line. Founders need to be wary of over-promising and over-issuing shares at the outset if there is an intention to use equity to raise funds down the line. The terms offered to investors can also set a precedent that other investors will expect to follow (for example, if you allow a ten per cent series A investor to appoint a director, it may be hard to get the series B investor to take twenty per cent at a higher value to not insist on at least the same representation). If a business relies too heavily on equity backed funding, there is a danger of over-diluting key figures and a reduction in the potential return available to the founders should there eventually be a sale or a public offering. It is also important to keep in mind that not all shareholders will necessarily stay with the business as it grows and so consideration needs to be given to over committing shares at the outset but also to be able to retrieve shares from parties that may eventually disengage from the business.

Keeping track of shareholdings and their value against the company's overall saleability is important but just as important is a business' governance. In simplest terms, this means how the business is run, who makes decisions and that there are procedures in place to ensure that if there is a breakdown in relationships, there is a way to resolve any issues so that the business is not detrimentally impacted.

It is vital that governance is properly documented. In the offshore world, this is usually done in the form of a written contract (usually a shareholders' agreement, but sometimes a subscription agreement, investment agreement, or joint venture agreement). This agreement is supplemented by and mirrored in the memorandum and articles of association, which are the constitutional documents of the company from a local law perspective – integrating these documents ensuring that the provisions have maximum force and effect. These will commonly include provisions providing guidance on what the company and the shareholders should do on matters such as the issue and sale of shares, the appointment & removal of directors, the calling of shareholder, and director meetings. It still set out who can appoint directors, and what matters need shareholder approval. Founders can also use these documents (where investors will accept it) to give themselves certain protections, such as enhanced voting rights or vetoes.

From a shareholder/investor perspective, understanding how and when they might be able to exit will be a priority. Provisions dealing with share transfers such as drags, tags and rights of first offer/refusal can be seen as boilerplate, but it is critical for both companies and their investors that they work mechanically. Equally, if the long term plan is to sell or IPO the company, the way ownership is structured needs to facilitate that eventual goal.

Getting ready for an IPO or sale

An IPO may be a goal from the start for many founders, while for others it will only emerge later as a potential option. The benefits of an IPO for founders are numerous – it allows access to a vast pool of potential capital which can fund the further expansion of the business, it conveys a degree of prestige, and it creates a liquid market in which early stage investors (including potentially the founders themselves) can dispose of part of their equity. With certain stock exchanges allowing the dual share structures and enhanced voting rights (used by the likes of Meta, Zynga and Alibaba) an IPO can even be achieved whilst allowing the founders to retain a high degree of control of the company's future direction. Both BVI and Cayman law allow such structures to be baked into the constitutional documents. As previously noted, SPACs also present an alternative route to market for some tech start-ups and Harneys recently assisted in taking SaiTech, a bitcoin miner, public through a SPAC merger[5].

Many jurisdictions now have specialist or junior stock exchanges which target start-ups (particularly in the tech sector) and offer a lighter touch regulatory regime but, even so, being a public company can carry with it additional burdens. Some start-ups can feel frustrated by issues of governance, compliance and legal 'niceties' affecting their ability to be nimble and execute their vision. Making disclosure of these issues in a public filing however is, at best, embarrassing. The companies that have the easiest time going public are those that have already started to make the mental adjustment and which are already operating like a public company.

While some founders may never want to sell their company, others will have that in mind as a potential exit at an early stage, and may even have a sense as to who might be a likely buyer. A potential sale, and the inevitable due diligence process, will be far easier if the company keeps adequate records. While some things may be rectifiable after the fact, complying with the law, and taking appropriate advice when issues arise, can prevent problems coming up in the due diligence process that may put off potential buyers.

5 https://www.harneys.com/news-and-deals/harneys-advises-saitech-limited-on-us-188-million-de-spac-transaction/

Economic substance

Both the BVI[6] and Cayman[7] now have rules which require companies incorporated there to have economic substance in the jurisdiction if they are conducting certain activities, unless they are treated as tax resident in another jurisdiction for these purposes (in which case they may be exempt). This may involve having employees, premises, or directors in the relevant jurisdiction, but may not. Advice taken at the outset, and ideally in pre-incorporation stage can head off any issues.

The detailed nature of the economic substance regime is outside the scope of this note, but there are a few things in particular that start-ups should be aware of in their structuring

1. Holding intellectual property in an offshore company is not a viable option unless the IP will be developed and managed in the relevant jurisdiction. We are seeing more and more clients in this space holding their intellectual property onshore.
2. While it is fine for companies to borrow and raise money through debt, acting as a lender, even intragroup is likely to cause an issue (unless the loan is provided for no interest or other consideration.
3. Care should be taken with any intercompany service arrangements where one company will be charging a fee or providing services to another company in the same group.

Final thoughts and advice

Structuring your business correctly at the outset is one of the most important things you can do to help prevent issues down the line and to support future success.

When you reach the point of major investment or even exiting, you don't want to be fixing issues that could have been avoided if more attention had been given at the outset. As the adage goes, prevention is cheaper than cure.

Offshore may not be right for you but you'll only know if you speak to us and with our wealth of international experience, we are sure we can point you in the right direction and assist in making your business a success.

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