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Debt-Free Path to Innovation

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A new exemption class over corporate regulation might be a better approach to innovation policy, write Sean Leaver and Jason Potts

There are already a number of different regulatory types of firms available, such as sole-trader, partnerships, private companies and public companies. However, a unique characteristic of start-ups firms is that they are more likely to fail than succeed. There is no company type available within the current regulatory framework that implicitly recognises this risk profile of start-up firms.

Malcolm Turnbull wants to reform corporate regulation— particularly to soften Australia's rather punitive bankruptcy provisions—to create new start-up friendly business laws. The National Science and Innovation Agenda Report proposes to reduce bankruptcy from three years to one year, allow directors to trade while insolvent, and stop counterparties from terminating dealings with insolvent companies.

Corporate regulation was never designed or intended to promote new business growth, but rather to control existing and particularly large, mature businesses. For the most part, it does this successfully. However, Turnbull's proposals fail to make a fundamental distinction between two very different types of firm failure. For start-up firms, particularly in the technology sector, a high failure rate is not only normal, it is often desirable. It's a sign of experimental undertakings and rapid learning.

Changing the bankruptcy period from three years to one isn't much of an incentive and won't change reputational risk associated with the stigma of bankruptcy. Bankruptcy appears on credit reports for five years and remains on a public National Personal Insolvency Index for life. Although directors of insolvent firms are protected from liability for a company's debt, the risk of significant penalties remain. Individuals can be barred for five years from directorships if they have been a director of more than two insolvent companies within seven years. Being a director of a company that trades while insolvent can lead to criminal penalties and potentially being liable for debts incurred while insolvent.

Applying the current bankruptcy and insolvency framework to innovation firm start-ups—where failure is treated as an exception— makes no sense.

But failure among ordinary, mature companies is very different and usually, a sign of mismanagement. Ordinary businesses have no implicit expectation of failure. There are legitimate reasons to have bankruptcy laws that balance the inherent riskiness of business and protection of counterparties who bare the cost of businesses failing. Consequently, lowering the bar for

bankruptcy will likely provide a greater incentive for opportunism by unscrupulous promoters.

Bankruptcy and insolvency are not the only obstacles start-up firms face. Increasingly, start-ups are being funded through alternative platforms such as crowd-sourcing, which generate micro-funding of typically around $50 per individual. If crowd-source funding is to be used for equity raising, as proposed by the Corporations Amendment (Crowd-sourced Funding) Bill 2015, the complexity of regulatory compliance and associated costs will have to be reduced significantly.

INTRODUCING THE NOT-FOR-DEBT COMPANY

To be effective, a new company type needs to be compatible with the unique nature of start-up of innovation firms. This new type of company needs to firstly, remove punitive costs on innovators (as directors) of failure that is associated with bankruptcy and insolvency; and secondly, allow innovation companies to cost-effectively raise micro-equity so that investors can diversify investments across a pool of high risk/high return innovation start-ups.

A specific type of company dedicated to start-ups also allows greater regulatory agility in rapidly adapting rules without impacting the wider regulatory environment.

We propose to call this new regulatory class a Not-for-Debt company (e.g. Startupco NFD). The Not-for-Debt company proposed is a new class of start-up company that by design is exempt from many corporate and financial regulations (along with the associated costs and burdens), that are designed to protect creditors.

It does so by the simple expedient of doing away with creditors and debt entirely, and clearly signalling that they are risky companies likely to fail—but with a significant upside if they succeed. With reduced regulatory restrictions, funding can be raised either by issuing traditional equity as shares or micro-equity via crowd-source funding platforms.

At a TechLeaders conference last year, entrepreneur and investor Tony Surtees spoke passionately about the need to let start-ups ‘fail positively’. The current legal framework for companies and directors punishes failure when we should be encouraging failure. Failure drives learning and learning drives innovation.

Start-ups by their very nature have the expectation that they will most likely fail. As Surtees makes clear, their very purpose is ‘experimentation—trying something new with an uncertain outcome’. How do we create a regulatory framework that has at its heart the mindset of ‘no fault failure’?

BANKRUPTCY AND INSOLVENCY NEED NOT BE FEARED

To discover something truly new requires trial and error, a process that necessarily involves a succession of failures before success. Knowledge grows through learning from failure. Entrepreneurs find it difficult to capture the benefits of learning from past failures on their road to success because current bankruptcy and insolvency law stops this learning process in its tracks.

The solution is to remove the risk a company will become insolvent by removing the ability of the

company to raise debt. Without debt there is no risk that liabilities will exceed recoverable assets. All potential creditors (broadly defined) would be aware that they are dealing with an NFD, and adjust their actions accordingly. If there is no insolvency risk, there is no need for onerous and punitive bankruptcy and insolvency regulations that inhibit innovation and formation of start-up firms.

A company's financial resources would be funded solely through equity placements or raising funds through crowd-sourcing platforms. An unsuccessful innovation company either closes down with no outstanding debts or remains dormant until further funds are raised. An NFD company will have some operating liabilities but, say, by requiring trade debt terms at no more than 14 days and staff liabilities no more than 60 days salary equivalent, these can be limited.

Moreover, the legal framework for innovation companies also needs to capture the 'real option' value of staged investing—a 'wait and see' strategy. Funding for any start-up always proceeds through multiple stages, with capital growing as more of the business is tested—the concept, business model, market demand, management team, and so on—and as uncertainty falls. At each stage, the real option value of the company changes.

This model already exists in the mining sector, in which a No-Liability company can form with no contractual right under its constitution to recover calls made on its shares from a shareholder who fails to pay them.

That is, an investor can opt out and take a loss on only the contributions up until that point in time. The advantage of the no-liability approach is that it reduces the regulatory costs of raising additional share capital.

Further, the ongoing tax and compliance costs of innovation companies and their investors need to be reduced. Financial and tax reporting for innovation companies should be prepared solely on a cash-flow basis.

For individual investors, there would be no tax-reporting requirements for original holders of issued capital for the first three years after issuance, unless the shares are transferred or the innovation company closes down. There is no point imposing onerous tax-reporting obligations for investments in companies that are likely to fail. The three-year reporting exemption also provides an incentive for patient investing.

RISK ASSESSMENT

Lastly, what of the likelihood of opportunistic and adverse behaviour that might follow from an NFD model?

There is a risk that NFD firms will be created to siphon funds into entities controlled by the promoters. This can be addressed by restricting the nature of related party transactions.

The only related party transactions would be salaries of equity holders and issuance of new equity to existing equity holders, all of which will need to be disclosed.

There is also the problem of public policy interventions that lead to adverse investor behaviour. Innovation policy should not be built around a framework of financial tax incentives, such as deductions or offsets. A focus on tax minimisation is likely to lead to an under-appreciation of the risks of investing in innovation companies.

Innovation policy tends to focus on the government doing more things to encourage start-ups by creating even more complex tax offsets, write-offs, subsidies and spend programs. Governments love innovation policy for this reason. But there is very little evidence that any of this actually works in fostering successful start-ups.

A better approach is to carve out an exemption class from the standard company structure and introduce a regulatory model that greatly simplifies and reduces the costs of company formation. A regulatory innovation that could well make Australia one of the most attractive places in the world for new startups and creative ideas.