COMMERCIAL FOUNDATIONS

LEGAL BASICS AND VALUE MAXIMISATION

WWW.SIMMONDSSTEWART.COM

....

Overview

....

> Looking after the legal basics can be boring, but it is an important piece in the jigsaw of activities that maximise the value of your early stage company.

> Keeping on top of the legals helps to manage risk and make the most of your commercial opportunities. It will also prove extremely valuable when you:

- need to raise capital
- negotiate a major sales, licensing or distribution deal with an international corporate (who increasingly do detailed due diligence on overseas partners)
- get approached by a potential buyer of the business (or you start your own sales process)
- want to IPO.

> On the other hand, if your legals are untidy, at best those processes will be slower and more painful and at the worst may kill your transaction. In all cases, fixing untidy legals after the event is far more difficult and expensive than it would have been to keep them tidy in the first place.

> No doubt your funds will be limited and lawyers are expensive, so you need to focus on the areas that will maximise value and that will be of most interest to potential investors in or buyers of your business. The areas to focus on are those that:

- secure or promote your competitive position – particularly those that will give you a dominant position in a particular market, allow you to charge a premium for your goods or services and/or which defend you against competition
- secure your revenues and (better still) revenue growth
- manage your costs and liabilities.

> These areas vary from company to company, but the following are common to most businesses:

- intellectual property
- sales and sales channels
- key employees
- key suppliers
- housekeeping.

© Simmonds Stewart 2008

- This paper considers each of these areas and makes practical suggestions based on our experience acting for early stage companies and investors in them, through to acting for buyers and sellers of mature and maturing companies (both via trade sales and via IPO).
- Our paper also covers some important related topics that most early stage companies need to get to grips with along the way:
  - company structure including shareholders and shareholder agreements
  - investment term sheets.

Intellectual Property

- For businesses with a high growth strategy, IP is usually very important.
- IP presents both an opportunity and a threat to your business:
  - IP, particularly patents and trade secrets, can deliver a dominant position in a market e.g. Sony and its Blu Ray technology. For others, IP doesn't of itself deliver a dominant position, but it is usually one of the elements that contributes to the development and retention of that market position e.g. the Trade Me brand (trade marks) and the look and feel of the website (copyright)
  - on the other hand, IP can be used by your competitors, particularly in overseas markets, to prevent you from competing with them effectively or from entering the market altogether.
- Investors in and buyers of high growth businesses will always focus on the IP position of your company. They will want to see:
  - a sound IP strategy that identifies and (as appropriate) protects your key IP
  - strong protection of any IP that is necessary to protect and maximise the competitive position of your business
  - evidence that your business doesn't infringe the IP (particularly patents but also trade marks) of competitors in key markets – usually called "freedom to operate".
- A good IP strategy includes:
  - establishing systems for identifying, capturing and appropriately protecting important IP (including requirements for IP and confidentiality clauses in contractor, employee and supplier contracts terms)
  - keeping records for key IP assets, including details of how those assets were developed – particularly those mainly protected by patent or copyright (e.g. in the case of software, who wrote the code, on what terms, was there any third party IP involved and if so on what terms?)
  - researching freedom to operate in key markets.
- A common issue that we see when we carry out due diligence for potential investors in early stage technology businesses is that founders often believe that they have "freedom to operate" because they have current patent

applications or even accepted patents in NZ and under the PCT system. However, while this indicates that the relevant patent office has accepted that the invention covered by the patent is "novel", it does not mean that invention can be commercialised without infringing other patents. It is also necessary to carry out (and document) freedom to operate searches in NZ and key overseas markets to ensure that there are no other patents in those jurisdictions that are broad enough to prevent you from operating in those markets.

> Freedom to operate searches are best carried out before progressing too far with patent drafting – better to get any bad news before you have spent too much money on patent applications or developing your business in a direction that creates risk of patent infringement. Often there is a "work around" in the early stages of developing your IP or your business that can minimise the risk of infringement.

Sales and sales channels

> At some point in the development of your company you are going to have to start selling your products or services – generally the sooner the better.

> Not all revenues are equal. To create value in your business, your revenues will ideally be:

- recurring
- contracted (particularly in B2B models)
- profitable.

> You will need to be able to demonstrate to investors in or buyers of your business as much of the above as possible. Ideally, you will have contracts in place with your key customers, and it is essential that you have contracts with your distributors and resellers.

> High growth businesses are particularly vulnerable when negotiating their first big customer, reseller or distributor deal. The party you are negotiating with will realise how keen you are to secure your first big contract, and how valuable the contract is likely to be for you. They are likely to try to exploit this to obtain favourable terms. This is natural, but you need to exercise considerable care as a bad initial sales/reseller/distributor contract could stunt the growth of your business and significantly damage its value.

> Risks to be avoided if at all possible are:

- surrendering IP ownership
- granting exclusivity, unless in a narrow market or for a limited term with clear performance targets
- giving the customer bespoke control over the development path of your products or services, or requiring you to maintain a version of your product or service for that customer alone.

> It can be attractive to offer a key customer shares or options in your business, to cement a cornerstone customer or partnership arrangement. However, this is often fraught with problems. Your customer's motivations are unlikely to be

aligned with yours – they will be focused on maximising their own competitive position, which is not consistent with you selling your goods and services to the widest possible customer base. And your options for future sale of your business are likely to be limited or (worse still) subject to the consent of your shareholder customer.

> Appointment of distributors and resellers in overseas markets is often an effective way to penetrate those markets and build sales. For many early stage companies this is essential, as the cost of building an in-market sales force is prohibitive.

> However, there are downsides to appointing distributors and resellers:

- the distributor/reseller will often hold the relationship with your end customer. This leaves you vulnerable to the performance of the distributor/reseller. It also makes you dependent on the distributor/reseller – if the distributor/reseller switches allegiances to one of your competitors, you may lose a significant proportion of your customers. You may also lose a significant number of your end customers if the distributor/reseller ceases business for any reason

- it is difficult to appropriately incentivise your distributors/resellers. If you set their remuneration too low, they will not be motivated to promote your products. On the other hand, set it too high and despite good sales you will fail to achieve a reasonable return

- setting minimum sales or performance targets is equally difficult. Set them too low, and there are no consequences for a distributor/reseller underperforming. But if targets are set high, the distributor/reseller will expect a long term and possible substantial and costly marketing support from you in order to justify the upfront cost the distributor/reseller will incur in ramping up to meet your targets

- fixing the term of a distribution/reseller arrangement is another problem. A short term is unlikely to motivate the distributor/reseller to invest in the promotion and sale of your goods or services in their market. On the other hand, too long a term and you may be stuck with an underperforming reseller.

> The more novel or unproven your products or services, the more these issues will be highlighted, as your distributor or reseller will not wish to commit to high sales targets, will want to be compensated for the higher cost of establishing your product in their market and will want a long enough term to enable them to obtain a reasonable return for their efforts.

> Given these difficulties, it is common for distribution and reseller arrangements to reach their “use by date” for one or both parties within a relatively short period, and your company could find itself in difficulty in its key market(s) and with an expensive problem to solve.

> From a New Zealand supplier’s perspective, the best solution will often be to build an “off ramp” into the distribution or reseller arrangements which allows a party to terminate or (perhaps) provides for the removal of exclusivity if the relationship isn’t working. This may not be easy to negotiate however.

> Some other tips about distributor and reseller arrangements:

- before negotiating with a distributor/reseller in a new country, think about registering your trade marks and web domain in that country. It is not

unheard of for a distributor or reseller to do this themselves when taking on a new supplier, and it may be difficult to prise those registrations off them

  - in some jurisdictions (such as the Europe Union), a distributor/reseller might be deemed to be a "general sales agent" of your company. This status may give them a right to claim compensation on the termination of their appointment for the goodwill they have built up in your business. Different laws like this make it prudent to take some local legal advice before appointing a distributor or reseller in a country for the first time

  - joint ventures with distributors/resellers for country or regional markets can address some of the problems with traditional distributor/reseller arrangements. However, joint ventures tend to have a finite shelf life, and once the going gets difficult it can be even more difficult to exit and bring the arrangements to an end. Specialist advice is desirable before you start joint venture negotiations.

....

Employees

....

> The employees of an early stage company are usually a key ingredient in the success of the business, particularly when those employees were involved in the creation of the business or of products to be sold by the business.

> Potential investors in your company (and most likely any potential buyer of the company) will require you to have employment agreements with all of your key employees, particularly the founders of the business who are working in the business. The main reasons for this are:

  - to ensure that any IP created by those employees (pre-and post formation of your company) is acknowledged as being the IP of the company

  - so that the main terms of employment, particularly salary and bonus, are clear

  - to place non-competition obligations on your employees after they leave your business (although for founders, additional and more stringent non-competition clauses will most likely be required in the investment agreement, shareholder agreement or sale agreement)

> Employment agreements are often overlooked by early stage companies, particularly for the founders of the company. The good news is, they aren't hard to put in place and this will reduce the "to do list" when talking to a potential investor in or buyer of your business. Your employment agreements should:

  - contain a broad IP clause stating that all IP created during or relating to their employment belongs to your company. If your business was in development prior to the formation of your company, the IP clause should require your employees (particularly founders) to assign any IP created for the business prior to the date of formation

  - contain a reasonable non-competition/restraint of trade clause to apply post termination of employment

> It is relatively inexpensive to have an employment lawyer prepare a standard employment agreement for you that addresses these issues, and it will be much

easier for you to implement that agreement on the establishment of your business and as each new employee joins rather than attempting to do so when discussions with an investor or a buyer commence. It may also help to minimise the damage to your business if a dispute arises with one of the founders of the business – the lack of IP provisions and non-competition clauses can be quite damaging to your business in those circumstances.

- It is common for early stage companies to consider employee share and option schemes as a means of attracting and incentivising employees. Some comments on these schemes:
  - these schemes raise quite a few issues. In particular, the tax and securities law implications of these schemes can be complex and expensive to address, and legal documentation is necessary to implement the scheme (including rules about when shares and options vest, what happens if an employee leaves, and drag along provisions if you wish to sell your business in the future)
  - if you want to implement a share scheme but are also considering raising capital from investors, it may pay to hold off, as opinions are divided among New Zealand investors in early stage/high growth companies about the effectiveness of employee share participation (beyond key executives). Some investors like and may require them, although they may want the terms of the scheme to be reset. In contrast, some investors dislike them and may be deterred from investing
  - if you expect to raise capital in the US, shares or option schemes are the norm, and most likely will be required if you want to hire US executives as part of their remuneration package.
- Finally, if you engage contractors to work in your business for long periods, you need to be aware that they may at some point gain the status of employees for employment law and tax purposes. This could give rise to both employment and tax liabilities (for which potential investors and buyers of your business will be alert).
- Obtaining employment law advice at an early stage on your contractor and employee arrangements should help avoid these issues.

Suppliers

- Negotiating terms with a supplier is not as exciting as signing up a new customer, but supplier arrangements can still have a significant impact on the value of an early stage business.
- If the products or services of a supplier are critical to your business, or if they give your products or services a competitive advantage, you will need to put in place an appropriate agreement that secures the benefits for you. A long term exclusive contract will probably be ideal for you, but long term exclusivity may be difficult without committing to minimum purchase volumes. A compromise may be to provide for an initial period of exclusivity, with this continuing if purchase volumes are met.
- Attention to arrangements with other suppliers is also likely to pay dividends. This is often overlooked by early stage businesses in the rush to become

established and achieve revenues, and for this reason disputes with suppliers are quite common over:

- the quality or specification of the goods or services to be provided
- the price to be paid for them
- ownership of intellectual property.

> These disputes can often come to a head when you are talking to a potential investor or buyer, as it is a point of leverage for any parties you are in dispute with and there is now a prospect of some money being paid. This won't necessarily be a deal killer, and investors in early stage companies in particular are used to dealing with these issues. But it may slow down your deal and cost you more than it should to sort the dispute out.

> Cash is usually in short supply in early stage businesses, and suppliers that are prepared to work for "sweat equity" can be attractive. Caution is needed though. Think about:

- whether the supplier is someone you want to work with long term as a shareholder in your business
- what they will contribute to the business long term
- how you will measure the value of the supplier's services – work done on a sweat equity basis has a habit of costing more than would have been the case if it had been invoiced for cash.

....

Housekeeping

....

> Company administration is like housework – dreadfully boring at the time but rewarding once finished. This is particularly the case if guests (investors or buyers) call on you unexpectedly.

> Investors in or buyers of your business will want to review your company records as part of their due diligence processes. This will most likely include:

- accounts
- management and board reports
- IP documentation
- sales, distribution and supply contracts, and standard terms of trade
- employment agreements
- Companies Act filing and company records including your share register, board and shareholder minute books, interests register, constitution and shareholders' agreement (if you have one) and details of prior share issues.

> Keeping all of those records up to date, nicely filed and indexed, in electronic as well as paper formats will enable you to immediately respond to any request for information from a potential investor or buyer, or from a major customer or distributor (who are increasingly undertaking due diligence on strategic suppliers, particularly in the IP area).

- As well as assisting discussions with investors etc to progress as quickly as possible, having your housekeeping in order will give those that you are dealing with a considerable degree of comfort about your professionalism and attention to detail. This is particularly important when you are trying to convince a potential investor of your ability to execute an as yet unproven business plan.

- On the other hand, if your records are in a mess or worse still you can't find key documents or if key arrangements are undocumented, investors in or buyers of your business are likely to be:

  - concerned that your bad habits will extend to the commercial and operational areas of your business

  - worried about hidden risks, problems and liabilities.

- This is a particular risk for early stage companies – you and your company are relying on investors etc buying into your business plan and vision for the company, rather than the financial or commercial track record of your business. In that case, your housekeeping is one of the tangible things that investors etc can look at to gauge the likelihood that you will meet the goals for your business. If your housekeeping is poor, it may deter investors altogether or if they are still willing to invest the terms that they are prepared to offer may be substantially less favourable.

- Bad housekeeping is still a risk for maturing or mature companies. In these cases, due diligence is likely to be more intensive as the price you are seeking is likely to be higher and investors or buyers will want to be satisfied that all of the assumptions justifying that price are valid (such as security of revenue streams, absence of liabilities etc). Missing records or bad documentation will drive the price down, will make the terms more onerous for you, will make the deal slower to conclude and may in some cases cause the deal to fall over.

- A common mistake that early stage companies make is to assume that their Companies Act administration is up to date if they keep their Companies Office on-line filing up to date. This is not the case – companies are still required to keep formal written share registers and minute books, and investors will expect to see these. The share register is particularly important – this register is the only legal record of the shares held by your shareholders, the details you file on the Companies Office website have no legal standing.

Company structure

- The structure of your company may not have a great deal of impact on the success of your products or services in the market place, but a good structure will help you to avoid problems as your business develops and grows. It will make it easier for you to raise capital in the future and ultimately to sell your business.

- Key lessons we have learned from acting for early stage and maturing companies and for investors in and buyers of them are:

  - start your business with a new, clean company free of historical baggage

  - if you are building your business around IP that pre-dates your company (eg IP you have been developing for a while, or IP that you are going to acquire from another party such as a university) it is essential that the terms on

which the IP is transferred to the company is well documented and that the IP transferred is as broadly defined as possible

- limit the number of shareholders in your company:

    - more shareholders means more work for you in getting decisions made and passing shareholder resolutions

    - having small shareholders in your company (with say sub-10% shareholdings) will make the governance of your company more difficult. The large shareholders will be represented on the board and will want to get on with running the company, but the position of small shareholders will always need to be considered and in some cases their consent will be required

    - the more shareholders you have, the more difficult it will become to raise capital from shareholders without breaching the Securities Act (which requires a prospectus and investment statement to be prepared). While there is no magic number, this can be a problem if you want to undertake a rights issue (ie a pro-rata share offer) when you have 10 or more shareholders (and sometimes less)

    - if you have 50 or more shareholders, you become a "code company" under the Takeovers Code which will make it very difficult for you to raise capital from existing shareholders. This is because if any shareholder would obtain or increase a shareholding of 20% or more in the company, a full takeover offer must be made or shareholder approval must be obtained, and in both cases an expensive independent advisers report must be obtained

    - **Critically, the Takeovers Panel has recently stated that in the case of joint shareholders or family trust shareholdings, each joint shareholder and each trustee counts towards the 50 shareholder threshold, meaning that a company with 17 family trusts holding shares might be a code company (assuming an average of three trustees per trust)**

    - usually, the more shareholders you have the harder it will be when you want to sell the company. Organising a sale with even a handful of shareholders can be like herding cats; the more shareholders, the more time consuming and difficult it is likely to be

    - professional investors such as angel investment funds and VC's are aware of all of these difficulties and will factor them in when considering whether or not to invest in your company and in setting the terms of investment (including valuation)

- provide in your constitution that new shares don't have to be offered pro-rata to all existing shareholders (if you don't say anything, the default rule is that all shares have to be offered pro-rata). Otherwise, you might find it difficult to offer shares directly to a new strategic investor, or (worse case scenario) you might have a desperate need to raise new capital from shareholders but you can't because a pro-rata rights issue would breach the Securities Act

- put a shareholders' agreement in place unless you are close to raising funds from professional investors (professional investors will generally have their own form of agreement that they will expect to be put in place). In our experience, the most useful things to address are:

- tag and drag along rights (this is absolutely essential)
- rules around new share issues (any shareholder consents required)
- pre-emptive rights for transfers of existing shareholders (although this may be best dealt with in the constitution)
- consider allowing the shareholders agreement to be cancelled or amended on a 75% shareholder vote, particularly if you have a number of small shareholders (otherwise you may be stuck with the agreement forever).

> Shareholders agreements also usually address director appointment rights, and have lists of "protected transactions" that require certain minimum approval rights. It is hard to get director appointment provisions right however, as circumstances change as shareholdings change in your company. Protective provisions are also difficult to get right, as they restrict the freedom of the majority shareholders to run the company and can give a minority an inordinate level of power. We generally favour shorter protective provisions for this reason, rather than a long "washing list" of matters requiring special approvals.

Investment Term Sheets

> Term sheets are widely used by professional investors to negotiate and record the key terms of an investment transaction in advance of completing full legal documentation and due diligence. This allows the investor to see if they can get a deal with the investee company without incurring too much cost.

> While term sheets are generally not binding (apart from provisions dealing with confidentiality and perhaps exclusivity and deal costs), they are very powerful documents because they summarise the terms on which the deal will ultimately be done and are treated by the parties as being commercially and morally binding. Therefore once you get to the stage of preparing formal documentation, it is usually quite difficult to depart from what was agreed in the term sheet, and doing so will often come at a cost in terms of reciprocal concessions that need to be made.

> When you are presented with a term sheet you need to recognise that:

- this is your best and possibly only opportunity to negotiate the substantive terms of the investment deal, but
- the term sheet will have been prepared for the benefit of the investor and needs to read in that light, and in all likelihood the investor has far more experience than you in negotiating investment deals and term sheets. This is likely to put you at a substantial disadvantage in what are critical negotiations.

> Even though there are some industry standard term sheets developing for angel investments (lead by NZVIF), negotiating a good term sheet is still a difficult task for an investee company. Getting good professional advice on the term sheet from the start of your negotiations is likely to be a significant help to you in obtaining the best terms possible from your investor; it should also make it easier to review and finalise the full legal documentation for your deal, as your adviser will already be up to speed on the transaction and shouldn't have to attempt to relitigate unfavourable terms agreed at the term sheet stage.