BUDDLE FINDLAY

Call me, maybe?

28 June 2013

In this article, Sacha Judd (former partner) describes some of the common problems she deals with so you can hopefully avoid repeating those mistakes in your ventures.

Wanna be starting something?

Innovative New Zealand businesses are taking on the world, launching globally competitive products and services, raising capital from overseas investors, and getting acquired by large multi-national corporations.

Technology has made starting a business much easier. Open source development tools and cloud-based hosting services have made it much cheaper to get a new product or service built and launched. Modern accounting tools like Xero make it possible to keep your finances in order. Online banking means your bills get paid on time and you can keep on top of your cashflow. The Companies Office even has an automated and streamlined online incorporation process. As a consequence, entrepreneurs in the startup phase feel very self-sufficient. The DIY attitude is part of what makes New Zealand companies so amazing to work with.

But, not so fast. There are some easily-avoided traps that I see entrepreneurs falling into over and over again. As a lawyer, it might seem like I have a vested interest in suggesting startup founders get professional advice early. But, the alternative is that they often end up paying people like me a lot more to clean up the mess later on, assuming that's even possible.

In this article, I'll discuss some things you should think about to make sure you are laying the right foundation for your startup. There are a few important choices that young companies can make early on that have significant consequences, particularly if you intend to raise money from external investors at some point in the future. If you follow this advice it should save you time and money, both by avoiding some obvious mistakes, and by giving you a good basic understanding to work from so that when you do decide to bring advisers on board you know what you need and what to ask for.

This is my advice about when to take advice.

The first thing to do is form a company so that your business has a separate legal personality. This is important to separate the legal liability for the business from your own personal assets, though in practice, if you are borrowing any money or opening a facility with a bank, you are likely to be asked to give a personal guarantee as well. Make sure you understand the effect of this, and get good advice before you sign. This advice applies whether you're a solo-founder or working with others.

If you are working with co-founders, you need to discuss candidly at the outset whether each of you will take an ownership stake in the business (shareholders), a governance role in the business (directors), or work for the business for salary or wages (as employees or independent contractors).

This can be a very tricky discussion to have at the start of a project you're all excited about, and one that is often deferred or avoided altogether. You need to talk honestly about each person's contribution and what value you each attribute to it. The tendency is often to just settle for an equal split of shares, because it seems 'fair', and avoids a hard conversation. However, that may not reflect the time and effort and expertise that each person is bringing to the table, and may lead to arguments down the road. More than that, academic research indicates that founder teams who avoid having these discussions up front, and agree to split their equity equally, tend to suffer (on average) a 10% discount to the pre-money valuation of their companies when it comes to their first financing rounds. Your company may actually be *worth less* if you don't go through this process at the start.

One useful tool I've found helps founder teams with these discussions is Frank Demmler's "Founders' Pie Calculator". This is a great starting point for working through what each of you brings to the table, how the rest of the team feel about the value of that contribution, and what your overall commitment to the business will be. It's not a magic wand for settling the question of your equity split, but it does give you a good framework for trying to have the conversation in an objective, unemotional way.

Once you've settled on the percentage ownership, you can form the company. The Companies Office makes it easy to do this yourself, but in some ways this masks the compliance that sits in the background. Did you know you're supposed to have a share register? An interests register? Opening minutes recording the issue of shares to each of the founders? You need to keep these and other records at the registered office of your company. It’s too easy to overlook this paperwork until you want to raise capital and the investor asks to see it, at which point it may be too late to put in place quickly and easily.

It’s (not just) a matter of trust

At the outset of a new venture, everybody involved is excited about the project, positive about its future prospects, and in agreement on most things. It’s hard to imagine a time when you might not feel the same way. But things change. One of the founders gets a great job opportunity to move to another country, or wants to take time out to start a family. One of you wants to expand into Australia, but the others think it’s a terrible idea. You get approached by someone who wants to buy the business, but only some of you want to sell. If you haven’t agreed anything in advance, you may find yourself in an incredibly stressful situation, facing disagreement without any framework to help you deal with these issues.

To avoid getting into this situation, all of the founders should, at the very least, get together and dream up all the best and worst scenarios that might play out. Talk about what you would want for an outcome in these cases, writing down everything that you agree. Ideally, you should take the next step and put a binding agreement in place to record your intentions.

A good, simple shareholders’ agreement should do a few things.

- It should reflect how decisions will be made. As a matter of company law, most decisions can be made by management. A few key decisions relating to the company require shareholder approval; sometimes 50% approval and other times 75%. Depending on your ownership structure, you might want to list out a series of key decisions that will require unanimous approval, or at the very least, a high enough threshold to give any smaller shareholders some comfort that the major founders won’t just do whatever they like. These decisions might include: entering into high-value or long-term contracts, raising capital, hiring senior employees, or major changes in business direction.
- It should state how you will be able to sell your shares should you wish to. Do you have to offer them to the other shareholders first (pre-emptive rights)? If a large enough number of shareholders want to sell, can they force the others to sell too (drag-along rights)? If the major shareholders want to sell, do they have to secure a deal for the minor shareholders as well (tag-along rights)? Are you free to transfer your shares to a family trust or investment company?
- It should deal with funding. If the company needs money, will you borrow from the bank? Do the shareholders have to guarantee this funding if that’s required? What about if you decide to issue new shares? Do the existing shareholders all have a right to maintain their existing percentages by putting in more money?
- It should cover what else you are allowed to do. The startup might not be the full-time focus for all of the founders at the outset. You may have some friends and family as initial investors. The agreement should cover restraints of trade, and whether shareholders are able to work or invest in other similar businesses.
- It should set out what you want to have happen if things go wrong. If someone doesn’t hold up their end of the agreement, do they have to sell their shares? To the other shareholders, or to the company? At fair value or at a punitive discount? If there are only two of you, and you have a fundamental disagreement, you may want to consider simple deadlock provisions rather than going through the time and expense of independent valuations of the business.

A good shareholders’ agreement is written in plain English, and is able to be understood by all of the founder shareholders. There will be the temptation to use a template agreement, but as you can see from the questions above, every shareholders’ agreement will be substantially different, depending on the number of investors and their respective levels of control (for example, a 50/50 company needs very different arrangements than one with a majority founder shareholder, and a number of smaller minority shareholders). There is really no substitute for getting some good advice on this, and getting everything documented and signed.

With your company correctly incorporated and a good shareholders’ agreement in place you can get on with the business of building something great.

If you want it then you should have put a ring on it

Intellectual property is confusing, particularly in the technology sector. Daunting terminology around trade marks and patents, coupled with overseas examples of accusations of infringement, 'patent trolling', and aggressive cease and desists, have made the whole area seem difficult and scary for new entrepreneurs.

You can either just bury your head in the sand, or alternatively there are a number of practical steps you can take to lay a good foundation for protecting your intellectual property right from the start.

First, think seriously about the name of your company, product or service. The spate of dropped vowels that characterised Web 2.0 businesses like Flickr and Tumblr served a valuable purpose in this context as an invented word is the easiest to protect. If a word doesn’t exist yet, you reduce the risk that you’re infringing on someone else’s rights, and you’re less likely to run into difficulties with trade mark registrations on the basis that your name is too 'descriptive'.

Even if you choose not to get creative with the English language, at a minimum you should search as extensively as you can online to see if your name is already in use either here or overseas, or if other companies in your industry are already using similar names or logos.

Over and above what you can find for yourself on Google, lawyers who specialise in this area can undertake more comprehensive searches for you using trade mark databases. The advantage of paying someone to help you with this is that they know what to look for and where to look. They can also then give you an indication of the risk of you moving forward with your chosen name, even if there is someone else out there using it or something similar.

Next, register your trade marks. Even though you get some unregistered rights just by starting to use your shiny new name and brand, a trade mark registration is easier to enforce, at least in the country where it is registered. Prior use only exists in the geographical area where your brand has a reputation, which in the beginning will probably be a very small, local area. So, if you’re planning to trade internationally, think about registering in other countries too.

Finally, make sure the company owns everything that you think it does. Often in the early stages the founders will be doing a lot of the development work themselves, but you might also pay other people to assist, get friends to help out, or even promise 'sweat equity' to others who might join the team in the future. Without oversimplifying matters, unless the company is paying someone to do the work and/or you have a clear agreement, the intellectual property in the work will ordinarily belong to the person creating it. Things can get more complicated if members of your team are working on this project after hours while they are in full-time employment. Often the starting point of an employment agreement is that anything you create belongs to your employer, even if you’re only working on it in the evenings or on the weekends. The last thing you want is to have the ownership of your code, or your product, become unclear.

You can minimise this risk by making sure everyone who is working on the idea has an employment contract or contract for services with the company, clearly setting out what they will be doing, and stating that all the intellectual property and improvements created belong to the company.

Where software is involved, make sure you have licenses for all of your source code. This is particularly true where you use open source code.

The golden rule should always be to make sure that what’s built for the company is owned by the company, and that this ownership is clear and uncontested. This might not seem important on day one, but next we’ll look at what it means to be 'investment ready', and why this matters whether or not outside investment is on your horizon.

It’s business time

Startups fall into a couple of different camps. For some, the main priority is finding their first customers, keeping them happy, and then finding some more. For others, the highest priority is finding outside investment to help realise their idea.

Regardless of your planned trajectory, whether you want to chase venture capital off the back of your idea, or only plan to look for money when you need to expand, it’s still sensible to run your company as if you might look for outside investment in the future. This essentially comes down to good 'housekeeping'.

First and foremost, keep a copy of everything you ever sign relating to the business. Everything. That means every cellphone contract, computer lease, bank overdraft application, domain hosting service or end user license agreement. (Yes, really. Even if you just click 'accept', save a copy or print it first.) Make sure everything is signed by both parties, and has a date on it. Services like Dropbox make this sort of record-keeping easy.

Make sure you sign things in the right name. Your accountant will give you the same advice – things that relate to the business need to be in the name of the company, not your personal name.

Always think about what you’re signing, how it might restrict you in the future, and for how long. There are a number of advisory services that will help with developing business plans or raising capital, but require the companies involved to sign contracts giving them exclusive rights for a period. Similarly, a simple confidentiality agreement signed early on with a company you later decide not to continue working with may prevent you from disclosing information to investors without their consent, even where your relationship with that company has come to an end.

Don’t let things continue indefinitely 'on a handshake', and don’t let key agreements expire and just keep going 'as is'. If you have a key customer or supplier arrangement, it’s much better if there is a contract that documents it.

The Companies Act contains some specific obligations around record keeping. Any change of directors needs to be filed promptly. If you issue new shares or transfer shares to others, prepare and sign resolutions and certificates recording the change. Always keep your share register up to date (not just the Companies Office website – contrary to popular opinion, that is not your share register). You also need to hold an annual meeting of shareholders, or alternatively the shareholders need to sign a resolution in lieu of this. This needs to be done before you complete your annual return online.

Keep meticulous records around your intellectual property. You should be able to demonstrate that everyone who worked on your code or product did so under a contract, and have signed copies of those contracts. You should also have licenses for all your code, including open source licenses.

Any potential investor will want to carry out some form of due diligence on your company. Depending on the stage and scope of the investment, this might be as simple as looking at your financial statements, and spending some time with you as founders. However, beyond the seed stage, investors will most likely want a much more comprehensive range of information. More than that, their investment is likely going to depend on the company providing a range of representations and warranties that the information you've provided is complete and accurate, which are essentially promises that, if they turn out not to be true, will result in you paying the investor to reimburse them for their loss.

During due diligence a potential investor will usually provide you with a standard set of requests for copies of the kind of information outlined above, but also ask a range of questions. Are you in breach of any of these agreements? Are there any disputes with customers or suppliers about your products or services? Have you paid all your taxes? Are you aware of anyone who might be infringing your intellectual property?

Responding to these requests can take time, and the better the records you keep along the way, the easier it will be to move through this process. When, or if, you decide to embark on the process of raising capital, or selling your company outright, is obviously a difficult and critical decision. Next we'll look at how you can set your company up with the right governance and advice to help you make those kinds of decisions.

I get by with a little help from my friends

Starting a business is hard work, and you'll want to get as much solid advice at the beginning as you can. We're lucky in New Zealand that there is a real culture of paying it forward, and many very successful business people are more than happy to meet for a coffee and give you feedback on your idea or your progress. Beyond this informal network you start to get into the key issue of governance. Who is running your company, and how are they doing it?

The traditional legal company structure is designed to separate ownership from management. The owners (shareholders) are not typically the people running the show (directors). In startup companies, however, founders tend to fill both roles. It's important for those of you who are directors to understand what that means legally.

As a director of a company you have a number of duties that you must comply with under the Companies Act. I won't cover all of the obligations on a director here, but the following are some of the key considerations that you should bear in mind when you agree to be a director.

Most importantly you must act in good faith and in what you believe to be the company's best interest. This is particularly important where a director is also a shareholder. As a director, your decisions need to put the company and not your own investment first.

You must "exercise your powers for a proper purpose". An example of an improper purpose might be issuing shares for the purpose of diluting another shareholder's investment.

You must not allow the company to "trade recklessly" – meaning letting the company's business be carried out in a manner that is likely to create substantial risk of serious loss to the company's creditors. For startup companies, where cash flow will always be tight, it is very important for the directors to focus on the financial statements regularly, and to think carefully about the obligations that the company is entering into. Directors must be confident the company will be able to meet its obligations.

All directors have a duty to exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances. This means that it's not okay to rely on your fellow directors to monitor and run the company. If you're not familiar with financial statements, you should get some good advice at the outset. Spend time with the company's accountant, and ask a lot of questions if you don't understand something. The Institute of Directors runs a number of excellent courses for people who are starting out covering governance, strategy and finance essentials.

If all of the founders are relatively inexperienced, you should think seriously about finding an independent director to join your board. Alternatively, you might decide to create an 'advisory board' of people experienced in your industry or sector, who are happy to provide advice and oversight on a regular basis.

But, how do you pay advisors in this situation?

It is very unusual for small companies to pay directors' fees, other than perhaps a nominal amount for an independent director's time and expenses. When it comes to advisors, some may have a standard hourly rate, and some may be more interested in a small amount of equity (both because they see upside in your company, and also because it is more interesting to them to have some skin in the game). The challenge for founders is to "value" the advice and input that these mentors might provide, without creating an onerous, long term commitment that is difficult to untangle if the relationship doesn't work out.

In the United States, where these relationships are more common, the Founder Institute has done some good work in developing a standard framework and simple agreement for providing equity to advisors. While this is US-specific (I've worked on a slightly streamlined version of a similar agreement for use in NZ) what is really valuable about this guidance is the schedule which sets out the stage the company is at, and the level of engagement from the advisor. For example, will they connect you with their network (and what does that even mean)? Actively promote you within their network? Or actively seek out funding for you? Do you expect them to meet with you quarterly? Monthly? Is their role just to test your assumptions by asking you lots of questions, or are you hoping they will give you proactive, strategic advice? All of these factors will contribute to how much you might pay them, or how much equity you might want to offer.

Ultimately it's critical for founders to be honest about their strengths and weaknesses, and to identify people who can bring real skills to help the business grow. Don't be afraid to interview potential directors and advisors extensively to make sure the chemistry and fit is right for your business, and as you would with any employee, trial the working relationship for a few months before you agree to make them shareholders.

I fought the law, and the law won

In the beginning, startup companies rightly focus on doing all they can to get the business up and running. There is often a reluctance to spend money on anything that doesn't 'make the boat go faster'.

Tech startup founders often view lawyers with suspicion, and sometimes for good reason. I've written this article because it frustrates me to hear, time and again, that founders have delayed or avoided taking care of their legal situation because they don't think it's necessary, or the problem seems too daunting, or they think they can't afford to get help. I hope that as people start to educate themselves about the basics, they'll plan better for the future.

Finding a good lawyer to advise you on these things, who understands you, your business, and the sector you're operating in, will be one of the best investments you can make.

This article was originally published as a two part series 'Call me, Maybe?' by Rowan Simpson in September 2012.

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