PREPARING FOR INVESTMENT

As a startup looking to raise capital, you'll most likely spend a fair bit of time thinking about your pitch to potential investors and, if you're lucky, the terms of any investment. When you're doing all this thinking (and doing!), it's easy to forget that a lot can happen after you pique an investor's interest enough for them to want to validate the quality of your product, your growth opportunities and your team's ability to execute.

And yet, this intermediate stage – often referred to as the *due diligence* phase – is crucial. It's when the seemingly lower order administrative issues like your corporate structure, contracts and intellectual property come into focus.

This update identifies those key issues and explains why they are important and what you can do to get prepared. Although we have prepared this update in the context of investment into your startup, the discipline of getting your house in order from a legal perspective will ensure that you are well positioned to scale up and/or exit when the time is right.

THE DUE DILIGENCE PROCESS

Although anyone thinking about investing in a startup is likely to have a reasonable appetite for risk, investors are unlikely to want to commit their money to a startup that has *unnecessary* legal risk – that is, risk that exposes your startup to disputes down the track, whether in relation to the ownership of the business or its assets (including core intellectual property), or the manner in which the business conducts its operations. It is therefore important to ensure that you've also got your house in order from a legal perspective – nothing says red flag to an investor like a business that hasn't taken the time or effort to iron out these key issues.

All savvy investors will conduct some *due diligence* before they commit to funding your startup. Due diligence is a common process in which investors will critically analyse the key facets of your startup to familiarise themselves with its structure, operations and arrangements and assess whether or not to make the proposed investment. The due diligence process is likely to include an examination of the assets (including IP) that your startup holds, the terms on which you have contracted with your key customers and suppliers; who owns what; the key members of your team and their employment arrangements, and any specific regulatory regimes with which your business needs to comply.

TIP

1. Make your prospective investor's job and the due diligence process easy by pre-empting their questions and disclosing relevant information and documentation in one hit.
2. Don't try to hide bad news, get in front of it early. The larger the investment the more the investor will want to know and nasty surprises can easily scuttle any deal.
3. Attached to this update is a Due Diligence Checklist which steps through some of the key information and documents that an investor might request from you (or if you want to be slick and proactive, that you might offer up) prior to investing. Ask yourself whether you have any notable gaps and if so, what you need to do to resolve them.

STRONG FOUNDATIONS

Make sure that you've got the right legal structure through which to conduct your business. The legal structure you choose will be important to the ongoing operation of your startup, and may be influenced by your long-term business plans.

Now is the time to ensure you and your co-founders are on the same page about equity in the company and that the equity split is formalised. Investors will want to know who owns how much of your business and on what terms.

TIP

Investors will want to know who owns and controls how much of your business and on what terms. Make sure that you can explain and provide evidence of the governance of your business to a prospective investor.

1. **Who owns what** – Ensure that your company has been incorporated, that the ownership structure is clear, that shares have been appropriately allocated, and that you have a shareholders' agreement that accurately reflects these arrangements.
2. **Who controls what** – It may be that day-to-day operations are conducted by a person or group of people, and critical decisions go to a vote, or perhaps all matters are voted on as they arise. Do you know which

decisions are meant go to a vote of shareholders (and how their interests are weighed against each other)? Can the CEO unilaterally make decisions in the interests of the company?

All of these issues should be dealt with in the constituent documentation that you prepared when you worked out what structure was best for you.

WHAT IS THE INVESTMENT FOR?

Investors are looking at your startup for (mostly) three core attributes:

- your idea;
- your intellectual property; and
- your team (including you).

It will be essential for you to ensure, as much as possible, that all of those three things are co-dependent. Investors should understand that your idea cannot be easily replicated without your intellectual property and that your team is the best one to bring the idea to the world. Each element is as important as the other – the whole startup is the target.

From a legal perspective, when conducting due diligence, investors will want to see that:

1. The company that they are investing in actually owns or has the necessary rights to exploit, commercialise, develop or otherwise use the intellectual property that it relies upon to conduct its business and sell its products and services.
2. You have, *where appropriate*, protected your idea from competitors with:
   - Non-Disclosure Agreements with key suppliers, customers, employees and contractors; and
   - Patents (if it makes commercial sense for you to get one – it doesn't always but if unique intellectual property is the basis of your startup it can be critical).

TIP

1. Identify the intellectual property that is central to your business, and then think about who owns it, who has the right to use it, and on what terms.
2. Make sure that all critical intellectual property (including any patents) is registered in the name of the company, or in the case of non-registrable intellectual property, that you have obtained a written assignment in favour of the company. This critical point is often overlooked by early stage startups that have used friends, independent contractors and/or other third-party developers to build their offering.

A word of warning: Try to avoid a scenario in which it becomes apparent during the due diligence process that IP assignments, if they were ever obtained, have not been sufficiently documented. Chasing an IP assignment at the eleventh hour prior to closing the deal from people who have long since left the business, and, more often than not the country, (particularly when they know that you're under pressure to procure it) is incredibly stressful and has the potential to derail the transaction.

3. If your intellectual property is a key component of your business, you should speak to an expert about what you can protect and how to best protect it – contrary to popular belief, you can't just patent everything!

WHO ARE THEY AND WHAT DO THEY DO?

Investors will want to know who is involved in your startup and they might be wary if it appears that the only thing tying your people to the business is a collection of hand-shake agreements and promises, particularly where those people are critical to the success of your business.

Ask yourself whether your critical people are tied to the company and make sure these arrangements are accurately documented. Not having adequate agreements in place with your key people can cause difficulties, including unexpected requirements to retrospectively pay entitlements, and disputes over intellectual property ownership and rights to the business.

TIP

1. Consider whether your critical people are tied to the company and ensure that you have appropriate employment agreements in place.
2. Consider offering equity vesting arrangements for co-founders and key employees to incentivise performance and loyalty. Create employment contracts with key employees that include confidentiality and appropriate non-compete clauses.
3. See our previous article on the steps you should take when working with interns, for more ideas on how to manage your employment relations.

DOCUMENT IT

Demonstrate your commercial sophistication to prospective investors by showing them that your startup is prepared for the common legal engagements that lie ahead.

If your business model requires a certain form of contract for numerous engagements (eg customer agreements, channel partner agreements, or terms of use) you should have a standard form of this agreement prepared and ready to go. This will reduce the time spent dealing with legal issues when these important transactions occur, and also ensure that your startup's interests are uniformly managed across your engagements.

Even better, make available the contracts that you have already entered into with your customers and suppliers (subject to confidentiality obligations). It's much easier to prove the stickiness of your customer base when all of your existing commercial arrangements are documented.

TIP

Think of your startup as a data room containing evidence of the potential value of your business. Having a snappy pitch is great but prospective investors will want to validate what they've heard. Documenting your arrangements (both internal and external) is key and starting that process early and making that information easily accessible will not only give your startup an air of authenticity and professionalism but will avoid a last minute scramble to collect the relevant information once an investor shows they're serious.

DO YOUR OWN DUE DILIGENCE

DO YOU NEED TO CONSIDER PAST INVESTORS/CURRENT SHAREHOLDERS?

Depending on the stage of your startup, you may need to consider whether you are bound by any earlier agreements or arrangements, which may restrict or prevent you from raising those much needed funds.

If you have bootstrapped your company from the get-go you might not need to worry about this. However, many startups get off the ground with a little help from friends, family and angel investors. You will need to consider how those investors will be impacted by the new investment – and conversely how the rights attaching to their shares might affect the investment.

TIP

1. Think about who your stakeholders are, and whether they might: (a) have any reason to want to prevent you from raising capital (eg, do they risk being diluted, or losing some control over your startup); and (b) have any legal grounds on which to restrict or prevent you from finalising the transaction.
2. You may find that earlier investors have conversion rights, which are exercisable on certain funding rounds. Think about whether any such rights might be triggered by your new round of funding, the risk of this happening, and the likely consequences.
3. Are there any procedures or requirements in your constituent documents that you need to comply with, which may be used to block your fundraising? This could include taking a decision to fund to your board or shareholders. Find out what these are and if you anticipate there being a problem, work out a plan to manage those.

ARE YOU OPERATING IN A REGULATORY MINEFIELD (AND ARE YOU PREPARED)?

Figuring out what laws and regulations apply to your startup and what you need to do to comply can be daunting, but at some point you are going to have to face and overcome any regulatory hurdles. Your chance at procuring investment will be significantly reduced if you can't promptly and honestly answer questions from prospective investors regarding your compliance with relevant regulation.

The list of potentially applicable regulations is large, but will generally be industry, service or product specific. Some examples of the matters you might need to consider are:

- Whether you will you be operating in a heavily regulated industry like health, financial services, food and beverage or consumers.
- Whether you need a special licence to operate (eg an Australian Financial Services Licence or Australian Credit Licence).
- Whether any privacy, spam or data protection legislation either in Australia or overseas impact your operations (now or in the future).
- Whether there any zoning or usage requirements that might restrict you from using your preferred premises.

TIP

A good starting point is to look at the established market participants in your chosen industry and see what licences and regulations affect them. As you progress, you should also seek professional assistance to ensure you are operating within the law and for any help obtaining any required licences. There may also be certain circumstances where it would be worthwhile running your approach by a regulator.

ARE THEY THE BEST INVESTOR FOR YOU?

The way that you engage with your prospective investors during the due diligence period will not only determine whether you attract investment at all, but will set the tone for your relationship going forward.

As the old saying goes, there is no such thing as a free lunch! Your relationship with your new investors will be critical to the success of your startup. Before you sign on the dotted line, make sure you have considered what kind of shareholder this investor will be.

TIP

Make sure that you understand:

1. The degree and type of involvement your investor intends to have (Are they taking board seats? Do they provide mentoring and network opportunities?).
2. How their other investments have performed. Don't be afraid to ask for references from other startups they have invested in.
3. Their ultimate goal for your startup and whether it aligns with yours.

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FUTURE PROOF YOUR ARRANGEMENT

Once you have found someone who is prepared to assist you with your fundraising, make sure that you future proof your arrangement with them. Think about the next steps that your startup is going to need to take, and make sure you are not restricting those plans by engaging with this investor. Conversely, if it is appropriate, you may want to consider locking the investor in by agreeing to participation or pay-to-play provisions in your agreement with the investor, to ensure they are committed to future rounds of funding.

TIP

The arrangement that you reach with the investor should reflect the type of investor you want – do you want active investors who have a say in day-to-day decisions, or do you want someone more passive, who will just provide their money and let you run the show?

You and your investor should be clear about their role, and your agreement with them needs to reflect that. For more tips on getting your agreement with your investor right, see our article 'The Term Sheet Decoded'.

ALLENS ACCELERATE

Allens Accelerate is a legal practice dedicated to supporting the Australian startup community and providing expert legal advice to startups, investors, and corporates and government agencies responding to disruption and investing in innovation. Contact our team for more information.

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DUE DILIGENCE CHECKLIST

This checklist provides an overview of the documents and information that potential investors may request from you before they commit to fundraising. They may not all be relevant, depending on the structure and focus of your startup.

CORPORATE DOCUMENTATION

- ☐ Copies of certificates of registration together with any certificates of change of name
- ☐ Constitution or equivalent constituent documents
- ☐ Shareholders' agreements or similar
- ☐ Details of any charges or other encumbrances over shares
- ☐ Management accounts and board minutes

FINANCING DOCUMENTATION

Details (including copies of relevant agreements) of:

- ☐ external loan capital, overdraft facilities/term loans etc
- ☐ hirepurchase or other finance leasing arrangements
- ☐ mortgages, charges or other security arrangements
- ☐ guarantees given by, or other material contingent liabilities of, the company
- ☐ any loan/financing arrangements with suppliers or customers/distributors
- ☐ any grants by government or other regulatory authorities or bodies currently outstanding or received

SUPPLIER AND SALES/DISTRIBUTION ARRANGEMENTS

- ☐ Details of all arrangements for the supply of:
  - (i) key materials, consumables and utilities; and
  - (ii) key services.
- ☐ Details of sales/distribution arrangements, including customer lists and details of pricing arrangements
- ☐ Standard terms and conditions of trading

OTHER CONTRACTUAL ARRANGEMENTS

- ☐ Details (including copies of written agreements/terms) of any other material contractual arrangements relating to operations, including partnership, strategic and customer alliance arrangements
- ☐ Details of which contracts are key to your startup

INTELLECTUAL PROPERTY DOCUMENTATION

- ☐ Details of all registered intellectual property rights including: patents; trademarks; designs; domain names; and business names
- ☐ Details of any material unregistered intellectual property rights including copyright (including logos, advertising materials etc), methodologies, confidential information, process information and technical knowhow, data and specifications, and details of who developed that intellectual property
- ☐ Copies of all agreements relating to intellectual property, including IP assignments, licences to and from the startup, research and development agreements, collaboration agreements, settlement and coexistence agreements and confidentiality agreements
- ☐ Policies and procedures in place to protect key confidential information

INFORMATION TECHNOLOGY DOCUMENTATION

- ☐ Details of any material software used, including:
  - (i) copies of all licence agreements;
  - (ii) details of who maintains and supports the software; and
  - (iii) details of any development, configuration or customisation/enhancement work performed in relation to that software and copies of all agreements relating to the design, development or configuration of that software.
- ☐ Details of any material hardware used in the startup, including:
  - (i) copies of all lease or hire purchase agreements relating to that hardware; and
  - (ii) confirmation of who maintains and supports the hardware.
- ☐ Details of all telecommunications services used within the startup and corresponding agreements relating to the supply of those services or the provision or maintenance of associated hardware and software
- ☐ Copies of all other agreements in relation to the supply, support and outsourcing of information technology
- ☐ Details of business continuity plans and procedures
- ☐ Details of security policies, protocols and procedures

PRIVACY COMPLIANCE DOCUMENTATION

- ☐ Details of compliance with the *Privacy Act 1988* (Cth) (if applicable), including your privacy policy, procedures and other relevant documents

EMPLOYMENT DOCUMENTATION

Details of employment/industrial relations issues and arrangements, including:

- ☐ employment agreements and standard terms of employment
- ☐ copies of employment manuals/policies
- ☐ details of superannuation/pension arrangements
- ☐ terms and conditions of engagement of any consultants or contractors used in the business