BIZCOMMUNITY

Five essential legal tips for tech companies

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13 Sep 2012

Many businesses, especially in the technology sector, are started with the objective of selling them one day. Even if that isn't on the cards, it's a rare company that won't one day want outside investment to grow the business. Your task as a business owner will be immeasurably easier if you lay some basic legal groundwork early on.

The less complex your capital structure and financial statements, the more reassured potential investors will be that they know exactly what they're getting themselves into. Consider the following before you ever need to open your doors, and books, to a potential investor:

Keep things tidy - especially in terms of shareholding!

Take action from the start by consolidating your balance sheet, especially your loan and funding as much as possible and maintain a clean shareholding structure to avoid uncertainty or confusion for investors:

1. Allocate shares to your founders and anchor investors early on. The later you leave it, the more value they have, and the greater the tax hit will be.
2. Beware of giving real shares to your employees (as opposed to phantom shares or other instruments that tract the value of the company). However, fundamentally, valuable members of the management team must have an equity incentive of some sort. This is especially relevant for software and other IT companies: determine who actually owns your fundamental means of production!

Make sure you operate within your legal limits

If you've built a product, be extremely careful that you own the "building blocks" and/or have a valid licence to use those components. In the case of open-source software, are you within the licence terms? Also make sure that your employees have all properly assigned to you the intellectual property rights to anything they develop in the course of their employment.

Pay attention to all the standard due diligence issues: Make sure that all existing contracts (employment, supply, lease, etc) are in place, up to date, and not overly skewed against you, that your incorporation documents are up to date, and so on.

Do your homework and come prepared

Having your house in order is but one of many things to consider as the next crucial steps involves finding an investor with a strategy and values that align with your business; and finalising and negotiating the deal. "The devil is in the detail" and there can be serious ramifications if the details of the deal are not negotiated on level playing fields. To avoid the pitfalls you may encounter during a negotiation, consider the following:

1. A term sheet exposes the bare bones of the fundamental commercial terms of the investment. By requesting this document early on it allows you to view the essential details. Before putting pen to paper on the term sheet it is crucial to understand which parts are binding.
2. Always compare the terms on which different investors would invest - often an entrepreneur is focused on the valuation of the company, hoping for a higher valuation and, therefore, a higher investment. However, there may be a significant "negative" value, such as founder restrictions, share claw back, rights of investors to sell (their shares and yours!).

Make sure that you hash out all the details prior to signing

Once the investor's attorneys draft the investment document the fees will be for your account (usually deductible from the advanced investment amount). Ensure the legal fees are capped and discuss who becomes responsible for costs should the deal not close.

Conclusion

So, you've cleaned up your books, negotiated the dream investment and you're left with the glow of success. But be careful what you wish for as this success will bring growing pains. If you want to make it out of the world of plucky pioneers into the big leagues you're going to have to adapt. Think of it as building the infrastructure that will maximise profitability when growth comes.

Bear in mind the actual cash should be the very least of what an investor in your business should bring. Far more valuable in the long run is the active involvement of someone who has been there and done that: the strategic alliances, the operational know how, the connections and the experience and knowledge they bring.

Growing pains will most probably manifest along the way, but that's ok if you've chosen the right investor. The rewards of growth will far outweigh any sacrifices. If you can prove you have the strength and discipline to run a business in which you are the custodian of other people's money, not just your own, the world is your oyster.

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