

“Equity Funding Stages – Legal tips & insights”

Presented by

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Tom has over 30 years' legal and business experience including:

- ✓ **working for local and major national Law Firms;**
- ✓ **being the majority owner and executive director of his former mid-tier Law firm;**
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Tom is also a regular publisher of articles and is one of Australia’s leading presenters of legal seminars to and for various professional bodies, associations and government authorities on a wide range of business law and professional development-training topics including:

WA Department of Commerce	Institute of Public Accountants	CPA Australia
Chartered Accountants Australia & NZ (CAANZ)	Governance Institute of Australia	Mortgage & Finance Association of Australia (MFAA)
Law Society of WA	National Electrical & Communications Assoc (WA)	City Insolvency Discussion Group
Innovation Centre of WA	Australian Hotels Association (WA)	Forum for Directors of Indigenous Organisations (FDIO)
LegalWise CLE	Small Business Development Corporation	Australian Computer Society
The Tax Institute	Australian Institute of Conveyancers (WA)	Institute of Certified Bookkeepers
Western Suburbs Business Association	Business Foundations Inc	WA Business Assist
WA Reckon Partners	WA Indian Docs Inc.	Australian Institute of Business Brokers (AIBB)

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What we'll (briefly) cover

- 1) Making sure you are setup in a structure which is "investor friendly".
- 2) What to do before approaching the first external investor (from seed to later stage),
 - what do you need to make sure you have organised (what mistakes do they often make)
- 3) What are the best-practice legal steps when bringing on a new investor (what has to be done vs what is recommended to be done).
- 4) When do you need an Nondisclosure agreement (NDA) and what are they for
- 5) Is Greater than 50% ownership control of everything in the Business?
- 6) The Investor wants to be a Director, what does that mean?

1. Making sure you are setup in a structure that is "investor friendly"

Many different types of business structures in Australia. For example:

- Sole Trader;
 - Partnership;
 - Trading Discretionary Trust (whether using a corporate trustee or not);
 - Unit Trust (whether using a corporate trustee or not); and
 - **Trading Company.**
- For appropriate, optimal contemporary structuring (plus R&D eligibility 🙌), we are really only concerned with **proprietary limited** and, potentially, public (yet unlisted) **corporations**.



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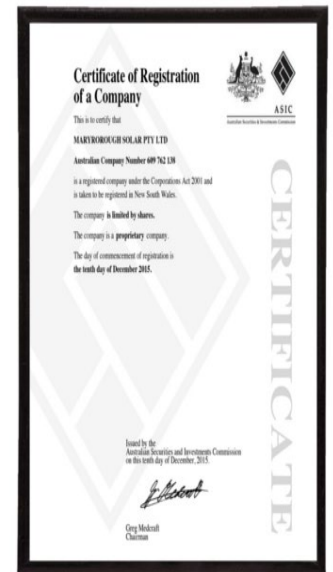
Business Structures and Rating Criteria:	Pty Ltd Company	Trust	Partnership	Sole Trader
Simple Paperwork and Rules	X	X	-	✓
Expense of Setup and Maintenance	X	X	✓	✓
Personal Liability Protection	✓	-	X	XX
Tax Benefits	✓	✓	X	X
Business Registrations	-	-	-	-
Overall Rating	✓	-	-	X

2. Before approaching the first external investor, what do you need to make sure you have organised.

With using a company, whilst they can be either outright established through ASIC or “bought off-the-shelf”, it is nonetheless very important to get the structure of the company; both as to its directorship and its equity holding (i.e. shareholding) correct.

A common mistake start-up companies do, either to ‘save money’ or out of inadvertence/ignorance is they choose not to have a company **Constitution** (which was similarly known as the Memorandum & Articles of Association before 2001).

- If a company is simply formed and established with ASIC but does not have a Constitution (i.e. a set of modern company ownership, operation and governance rules) ratified by all its shareholders then the directors, secretaries and shareholders (also known as members) will need to rely on the *Corporations Act’s* ‘replaceable rules’,
 - which are very basic and have a number of significant limitations compared with an appropriate Constitution. <https://asic.gov.au/for-business/registering-a-company/steps-to-register-a-company/constitution-and-replaceable-rules/replaceable-rules-outlined/>
- Please note: unless specifically advised by your tax accountant, it is not recommended to use/issue any other classes of shares (e.g. non-voting, preference, redeemable shares, also known as ‘alphabet shares’ e.g. A, B, C class shares; you can also have ‘partly-paid’ shares); other than **‘Ordinary shares’** when establishing a start-up company.





2. Before approaching the first external investor, what do you need to make sure you have organised (cont'd)

A) Next, in addition to having an appropriate Constitution for your start-up company, if there is more than one shareholder, then it is highly recommended to put in place an appropriate contemporary **Shareholders (or Equityholders) Agreement**.

- This is a 'contract' between those parties**.
- Again, which significantly augments and enhances upon the company's Constitution, corporations act, common law and recommended contemporary company ownership provisions.
- **Note: it is a bit of a misnomer to call it a 'Shareholders Agreement' when it actually should have not only the shareholders, yet also the directors and the company itself, as parties to that material agreement.



2.1 Contemporary, Shareholders Agreement for a Pty Ltd Company

Front 'Reference' Schedule – setting out key particulars, shareholdings, plus specific party and business information;

- Definitions and interpretation;
- Good faith & business purpose;
- Allotment and transfer of shares;
- Management and operation of the Company (board and shareholder/member meetings),
 - appointment of board;
 - function of board;
 - managing director's (if applicable) responsibilities;
 - adoption of annual program;
 - financial management;
 - shareholders' meetings;
 - particulars of shareholder voting; and
 - being a 2-member company, we will provide shareholder resolutions to be made unanimously, but with the provision that if more persons come on board, certain matters can be dealt with by majority;
- Company funding from/by the parties;
- Company policies, also providing for minimum ownership thresholds (as a percentage of shareholding, e.g. 20% in the event the shareholders wish to invite new investors/partners) that entitles a shareholder to be a director/on the board;
- Pre-emptive rights on voluntary sale of equity;
- Agreed equity-dilution clarifications and limitations
- 'Drag and tag-along' rights on sale of shares
- Sale of equity following a 'succession event' (e.g. death, total & permanent disablement, serious breach of the agreement etc);
- Establishment of market value of equity;
- Financial statements of the Company;
- Penalties and forfeiture;
- Restrictive covenants/restraints of trade;
- Confidentiality and intellectual property protection;
- Guarantees and indemnities;
- Bank accounts authorities & limits;
- Encumbrances & securities;
- Agreement to prevail over Constitution;
- Involuntary, insurance funded succession event agreements (if applicable) to prevail over Shareholders Agreement;
- Further assurances;
- Notice provisions;
- Default in payment
- Need for attorneys and executors;
- Party's obligations;
- Charges and other dealings;
- Variation;
- Termination;
- Dispute resolution;
- Deadlock;
- Duties, taxes, costs and expenses;
- Binding effect;
- Time is of the essence;
- Voluntary execution and advice;
- Conditions precedent;
- Special conditions; and
- Miscellaneous/general provisions, including:
 - waiver;
 - entire agreement;
 - involuntary departure not covered by agreement;
 - severance;
 - assignment;
 - power of attorney;
 - misuse of assets;
 - governing Law and jurisdiction; and
 - agreement is a deed;



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2.1 Shareholders Agreement for a Pty Ltd Company (cont'd)

- Back Schedules, including:
 - Schedule 1 – Buy option notice form;
 - Schedule 2 – Sell option notice form;
- Schedule 3 –
 - ❖ part 1: succession events (“**bad leaver**” provisions receiving 80% market value);
 - ❖ part 2: succession events (“**good leaver**” provisions receiving 100% market value); and
- Schedule 4 – special conditions.

Succession Event the occurrence of which will result in payment of the Purchase Price being calculate date the rate of 75% of the then Market Value	Option held by Retiring Shareholder	Option held by each Continuing Shareholder	Time by which Option must be exercised
1. If a shareholder's Equity has become the subject of an enforcement process (e.g. PSSO) following a judgment debt of \$10,000 or more and which debt is neither the subject of appeal or discharge within thirty (30) days of date of judgment.	Sell Option	Buy Option in respect of a proportion of the Retiring Shareholder's Equity which is equal to the proportion that the Continuing Shareholder's Equity bears to that of other Continuing Shareholders.	Three (3) months from the Succession Date.
2. If a Shareholder or its related Director or employee (as the case may be) breaches any Essential Terms of this Agreement and fails to rectify the breach within fourteen (14) days of written demand to that effect by the other Shareholders or the Company.			
3. If a Shareholder or its related Director or employee (as the case may be) is convicted of an indictable offence leading to a possible prison sentence of 12 months or more			
4. If a Shareholder or its related Director or employee (as the case may be) is guilty of unprofessional conduct resulting in the cancellation, suspension or restriction of their relevant license or practising certificate in Western Australia or any other jurisdiction.			
5. The bankruptcy or liquidation of a Shareholder or related Director or employee (as the case may be).			
6. If a related Director or employee (as the case may be) is, by the unanimous decision of the other Shareholders, dismissed from their employment by the Company for breach of employment by serious misconduct.			
7. If a Shareholder or its related Director or employee is absent from work for more than 3 months, other than in respect of any leave entitlements.			

Succession Event the occurrence of which will result in payment of the Purchase Price being calculate date the rate of 100% of the then Market Value	Option held by Retiring Shareholder	Option held by each Continuing Shareholder	Time by which Option must be exercised
1. If a Shareholder's related Director or employee (as the case may be) has, by reason of unsoundness of mind or of ill health, become incapable of being involved in Full Time Employment for a continuous period of six (6) months or more.	Sell Option	Buy Option in respect of a proportion of the Retiring Shareholder's Equity which is equal to the proportion that the Continuing Shareholder's Equity bears to that of other Continuing Shareholders.	Three (3) months from the Succession Date.
2. If a Shareholder's related Director or employee (as the case may be) dies.			
3. If a Shareholder's related Director or employee (as the case may be) is married or has been living with a partner in a marriage-like relationship with a person of the same sex or different sex (or howsoever described) or a de facto relationship as defined by a Commonwealth, State or Territory law, and begins to live separately and apart from her or his spouse or partner in a manner that constitutes a separation for the purposes of a Commonwealth State or Territory law, and has not settled within three (3) months of their separation, by way of court order or financial agreement, the financial claims or rights arising from the relationship of both the individual and her or his spouse or partner.			
4. If a Shareholder is unable to provide the monies as required pursuant to a Drawdown Notice issued in accordance with clause 5.4 of this Agreement.			



3. What are the best-practice legal Steps when bringing on a new Investor (what has to be done vs what is recommended to be done)

➤ In addition to first also obtaining appropriate accounting/tax, financial, insurances, R&D, intellectual property advices etc, the key to doing this properly is ensuring that you have the discipline and rigour in always following the steps:

- 1) Before discussing anything confidential or which may have proprietary information, intellectual property know-how or potential trade secrets absolutely ensure that you have properly executed **Non-disclosure Agreement/Confidentiality Deed** (“NDA”) in place with the relevant parties (also ensure you verify whom you are exactly dealing with).
 - ❖ From there then you can release some* key information about the company. Yet again noting they haven’t paid anything; *so ensure you do not give away material business plans, proprietary know-how, or even key IP even under an NDA.
 - ❖ There will always be a competing interest for an investor to ensure they have enough visibility on the company before they invest in it - though haven’t paid anything vs you maintaining that edge - hence the vital importance of an NDA.





3. What are the best-practice legal Steps when bringing on a new Investor (cont'd)

Next, if the investors are wishing to actually invest (usually in the form of taking equity as opposed to a loan; though it could turn into a hybrid scenario such as a Convertible Note!), then an appropriate **Term Sheet** .

- Also known as a *Memorandum of Understanding, Heads of Agreement* and, more commonly nowadays, *as a Non-Binding Indicative Offer* (yet which still could be binding!).
- A Term Sheet usually contains important, key aspects of the investor's proposed offer/'deal' such as:
 - the pre-investment valuation of the company;
 - the amount of money to be invested (and % of ownership of the company's equity)
 - plus the terms & conditions on which it will be invested;
 - whether there will be any escrow or restraints on the Founders;
 - whether the investors may also be entitled to be appointed a Director;
 - what influence or control the investors will have in the decision making*** ;
 - anti-dilution rights and protections for the investors; and
 - any dividend policy (if any).

Term Sheet Format

Term Sheet Contents

Business information	Security type
Valuation	Amount
Liquidation preference	Stake in percentage
Investor commitment	Founder's obligation
Time Frame	Voting rights
Closing date	Non-disclosure requirements

3. What are the best-practice legal Steps when bringing on a new Investor (cont'd)

➤ If the investor is going to actually invest in the Company's equity, then an appropriate:

a) **Share Subscription Agreement** (for issue of additional shares by the company to the new investor shareholder parties)

as opposed to:

a) **Share Sale Agreement** (for the transfer of existing shares usually from the founders).

***Pro tip: Notably it is *absolutely critical* that, and is a condition precedent of either the Share Subscription or Sale Agreement, the investor party together with the continuing shareholders (plus any new director(s)) also enters into the **Shareholders Agreement**.

- (or a 'Deed of Accession', if a substantive Shareholders Agreement is already in place).





4. When do you need an NDA and what are they for?

- In connection with any proposed due diligence activities by interested third-parties (e.g joint venturers, external contractors etc) and/or potential investors, you should have contemporary, robust**** NDA/ Mutual Confidentiality Deed.

It should deal with at least the following:

- Confidentiality
 - Disclosure to Representatives
 - Protection and Security
 - Ownership of Confidential Information and Intellectual Property
 - Return of Confidential Information and Intellectual Property
 - Protective Covenants (Anti-Poaching)
 - Breach Of Obligations and Indemnities
 - Continuing Obligations
 - Disclaimer
 - Privacy
- When preparing an NDA, you should err on the side of thoroughness and best practice for your company's optimal protection yet may also make it reciprocal/two-way. Hence the 'mutual' aspect (not that you'll often be needing to know anything confidential or otherwise about the other party, yet it may make them feel better).



4. When do you need an NDA and what are they for? (cont'd)

Further as we often advise, there's absolutely no legal nor commercial risk in someone signing an NDA, **unless** they intend to breach it!

- So if anyone says "Aww that's just a lawyer's document!", "We're good friends, let just shake hands because we trust each other" or whatever, beware. As I always say: "Everyone is in love on their honeymoon..."
- You also need to confirm the correct details for your company and all the relevant party(ies) (e.g. their full name address, ACN /ABN etc) - that is a **very** important aspect of the NDA's validity & enforceability, and which I discuss further below.
- We use a definition known as "Express Purpose" for the NDA. That definition can be 'toggled' in other relevant iterations of your NDA; namely it can suitably changed or adapted to suit the particular context of investment opportunities, or any other sensitive commercial situation or business use you may have need for it.
- ❖ **Importantly** as this is a 'deed' (it's not actually "agreement" per se), in order to make sure it is legally valid, binding and enforceable, it is critical the signature/execution parts are correctly done and, where any party is an individual, then their signature *must be witnessed by an independent adult*. See also [this link](#) for more information about execution of Deeds.
- Finally please remember an NDA can assist following a disclosure or breach of IP but cannot stop an inadvertent (or deliberate) disclosure, gross negligence or fraudulent misconduct.
 - Therefore, you should still carefully consider what information to disclose and/or provide access to an investor or third party, especially if it contains any absolutely unique or financially sensitive information, or information about relationships/clients/contracted parties which is commercially sensitive.





5. Is Greater than 50% ownership control of everything in the Business?

- **No. Though it does have the potential change the 'power balance'. Having a controlling interest may give a shareholder (or group of shareholders) a significant influence over the actions of a company.**
- In most cases, however, all (ordinary) shareholders will usually have the right to:
 - attend shareholder meetings;
 - vote on key issues, such as appointing a new director or dismissing an existing director;
 - sell their shares (although this right is restricted in most cases especially if there is a Shareholders Agreement in place);
 - receive company reports and announcements;
 - participate in corporate actions (such as the issue of more shares, share buybacks or mergers); and
 - receive dividends and other distributions.



Subject to the relevant Shareholders Agreement, and whether it is a *general or special majority (usually 75% or greater)* controlling interest, it gives a person or group of people substantial influence.



5. Is Greater than 50% ownership control of everything in the Business? (cont'd)

Similarly so for the number of directors appointed to the Board of the company. However the rights and responsibility of company directors are legion!

<https://asic.gov.au/for-business/small-business/starting-a-company/small-business-company-directors/>

- Board directors and a chair make up your board. The core role of the board is governance of the company. The Board's responsibilities are to:
 - establish a governance framework, including a compliance framework to ensure the company meets its obligations;
 - set the strategic direction to help the company achieve its purpose;
 - oversee financial performance of the company;
 - oversee a risk management strategy and risk management performance
 - play an active role in building a culture of integrity by modelling the behaviours based on the public sector values and standards
 - oversee the performance and remuneration of the company executives and employees;
 - operate within its statutory powers and policies;
 - oversee the occupational health and safety of the company (e.g. its workers);
 - manage stakeholders.
- ❖ **Your company may have a unique or tailored governance arrangement under legislation. It is important that you are aware of any specific governance responsibilities and requirements for your company.**



6. The Investor also wants to be a Director, what does that mean?

Could be good, could be bad.

- If they are an already experienced company director, and even if they are a minority investor, they could bring significant alternate expertise, business acumen and additional insights to your company's board.
- If they have no experience as a modern company director (yet say just have lots of money and/or influence) it could be a compliance and governance nightmare allowing them to be also a director!
 - Note: you can contractually have in Shareholders Agreements, a 'threshold level' to appointment. Which mean that, until an investor reaches a certain minimum percentage of ownership of the shares in the company (e.g. 20%), they are not entitled to be appointed as a director.
 - ❖ Other times you could additionally make it a condition they are required to satisfactory pass the highly-regarded Australian Institute of Company Director's (AICD) course <https://www.aicd.com.au/courses-and-programs/all-courses/company-directors-course.html>
 - Otherwise it may be a bit like someone having financial wherewithal to buy a high-performance vehicle, yet they have never done any advanced driver & safety training before taking it out on the racetrack!





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