# ARE YOU READY FOR VC?
# 10 Legal & Business Matters To Address

## 1. Protect your Ideas

Digital media and other technology companies derive most of their value from their innovative ideas, or intellectual property (IP). That IP isn't nearly as valuable, and you won't be nearly as attractive to venture capital (VC), if you can't stop others from copying or using your IP.

Before you go to market and tell the world about your great ideas, find out what protection is available for your IP. There are some basic steps you can take (without spending a lot of money) to ensure your IP is not used by others, and continues to give you a competitive advantage. Consider patent and trademark registrations, and make sure employees and others developing or having access to your IP assign any rights to you and enter into confidentiality agreements.

You should also check to make sure you're not using someone else's IP in a manner that's infringement, which can happen even if it's independently developed by you (not copied).

## 2. Incorporation

Most businesses should be carried on through a corporation, keeping business assets (including your valuable IP) and liabilities separate from those of individual owners (or shareholders) and providing a vehicle for investment, whether that's VC or seed capital from angel investors, founders, family or friends.

Incorporate early and avoid the added complexity and cost of transferring the business to a corporation later.

Once you've incorporated you should maintain the corporate records properly, particularly documents relating to the issuance of shares (more on this below), appointment of directors, and authorization of changes to the principal corporate documents (such as the share terms and other provisions in the articles of incorporation). Without proper records, VCs may be concerned that prior transactions have not been properly authorized or are not in compliance with applicable laws, which can adversely affect the corporation or the VC's rights as a shareholder. Even if these deficiencies are unlikely to actually cause problems, VCs will be concerned these "skeletons in the closet" may hurt their ability to sell the company or take it public.

## 3. Issuing Shares

When issuing shares of a corporation:

- Pick your shareholders with care – consider whether you want the person to be an investor in your business; even a small shareholder can be a nuisance and hard to get rid of (without a shareholders' agreement with the right provisions). More on this below.
- Consider securities laws – make sure each issuance of shares is exempt from securities laws applicable to public offerings (IPOs). They generally will be for founders and family, but friends and angel investors may not qualify. VCs will want to know the prior share issuances are not "off side" – another "skeleton in his closet" that makes your company less attractive and may hurt your ability to raise funds.
- Document the issuance of shares properly – without this, you may not be able to show with certainty the number of shares issued and who the shareholders are, or demonstrate compliance with securities laws, which can be a major concern to VC.

## 4. Shareholders Agreement

You need a shareholders agreement to deal with:

- Decision-Making – What decision-making (or control) shareholders have (or don't have). Relying on a "majority rule" (based solely on shareholders voting rights) without a shareholders agreement is fraught with problems – it can result in shareholders, large or small, having too much control over some decisions, or not enough over other decisions.
- Finances – How the business will be funded; that is, obligations of existing shareholders to advance additional funds or give guarantees, and any restrictions on accepting new shareholders (such as pre-emptive rights) or obtaining bank loans.
- Distribution of Profits – How any profits will be distributed, whether as dividends or bonuses to employee shareholders.
- Sale of the Company – Absent a shareholders agreement, shareholders generally cannot sell, or be forced to sell, their shares, and a sale of the corporation's assets may be blocked by minority shareholders. You may want the right to buy back shares after a shareholder ceases to be actively involved in the business (which, following death, can apply to a shareholder's heirs). A majority of shareholders should be able to force a sale of the company if not all shareholders agree – a "drag-along" provision is essential to be able to force all shareholders to sell their shares.

## 5. Key Contract Provisions

Contracts key to your business (e.g. IP licenses, long term or large value customer contracts) should have appropriate provisions when dealing with matters such as ownership of IP, liability, indemnification, termination, and assignability. You should have a good standard form contract for ordinary course repeat transactions (e.g. end user license agreements) and have significant “one-off” agreements reviewed by a lawyer.

VCs will review contracts as part of their due diligence, and serious flaws, particularly those that fail to protect ownership of IP or leave your company exposed to potentially large liabilities (even if only contingent and unlikely to materialize), can jeopardize a deal.

## 6. Business Strategy and Proof of Concept

Do you have a well thought out business strategy for your business? What is your value proposition, how will you go to market, which market and verticals are you targeting, what's your pricing strategy, how are you going to scale the business, and do you have product development roadmap? If some of these pieces are not yet defined or clear, approaching VCs too early may produce a negative first impression and hinder your chances of raising capital.

Unless you’re a serial entrepreneur who has made money for a VC before, it is unlikely that a VC would invest in your business before seeing proof of some traction of your product/service in the market. It’s important to win a couple of meaningful clients to validate the potential of the product/service to VC.

## 7. Pitching your Business to VCs

VCs meet hundreds of companies and need to quickly decide whether the business they are looking at deserves investing their limited time. Listening to pitches every day makes it relatively easy for a VC to rapidly brush off less attractive opportunities.

Before getting in front of one of them make sure your pitch is well rehearsed, short and crisp. At a high level a few key elements should come across very quickly and clearly:

- what is and how big is the market opportunity
- what is the value proposition of the business to address the opportunity
- why is the business going to win against competitors
- what is the business model and business strategy
- management team competence and ability to execute

- what are likely exit scenarios

## 8. How Much is Needed and How Will the Funds be Used

When trying to raise money for your business, one of the first questions will be around the amount and use of funds. A clear idea of the amount needed and how this ties to the growth of the business (backed by a business plan and financial model) will be expected.

One dilemma often facing entrepreneurs is the speed at which to ramp up the business, which is often contingent on the availability of resources and capital. For VCs it's critical to understand how the deployment of more or less funds is going to translate into top line growth. The quantum of the funds sought should be considered in this context and should provide flexibility to allow the business plan to still be executed if growth this materializes more slowly than anticipated. You don't want to run out of funds because you're six months behind in your plan.

## 9. Value Expectations

At the early stages, the value of a technology company is highly debatable and subjective. A number of factors will play a role including the size and growth potential of the market, scalability and competitive advantage (including IP protection) of the technology, path to profitability, capability of the management team (skillset, prior experience building a business successfully) etc. Ultimately, it comes down to the prospect of the business generating cash flow in the future, which depends on many assumptions. Views on these assumptions, and therefore value, will differ.

Speak to as many VCs as you possibly can and get their view on how they would value your business. It is important for you to be realistic. If the general consensus on the value of your business is significantly less than your own valuation, consider the following:

- If you've talked to a sufficiently representative group of VCs and they all indicate a similar value, then probably that's what the market is willing today to price a business in your sector and with your characteristics (this may have a lot to do with perception of the attractiveness of a sector at a given point in time)
- Investors are investing to make money and need to believe that a market risk adjusted return can be achieved.
- This will likely not be the last time you need to raise funds, and it will be important from a story and optics perspective to do the next round at a higher valuation (it's all about growth). If you price too high today you may be pricing out future investors, increasing the risk of a "down" round (a financing done at a valuation lower than the previous), and have unhappy investors on board.

## 10. The Right VC for Your Business

What are you looking for? Not all VCs are the same and you'll be well served by doing due diligence on them, just like they'll do on you and your business. It is a good idea to start this process early, before you're running out of money, so that you'll have time to explore different options and have more flexibility.

When you take VC money you also partner with sophisticated investors that will have a say in how you run your business. At a minimum, you should be comfortable with the individuals (who will most likely be sitting on your board) and find out about their experience with other investments and entrepreneurs.

What do potential VCs bring to the table? Is it only capital, or are they going to be able to open doors for your business? Will they be passive or active investors? What is their attitude? Will they back you up if things get tough (e.g. provide more funds) or run for an exit? What kind of rights are they looking for as part of their investment? Will they be an asset or a liability when trying to attract more investors down the road (connections, reputation, terms of their original investment, association with a strategic party, etc.).

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### a cautionary note



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