



## IMPORTANT NOTICE

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## Don't Rush Past the Legal Setup

### GET YOUR LEGAL FRAMEWORK RIGHT WITHOUT EATING INTO YOUR STARTUP CAPITAL OR CURBING YOUR MOMENTUM

You started your business with a vision of exactly what success looks like for you. You'll work harder than you ever have before in order to reach that dream and it will feel like your 'to do' list only ever grows.

In these early days, there are protections you should put in place to make sure that, on the day when you reach success, it isn't taken away from you.

So don't rush past this. Most entrepreneurs are surprised to find that the protections they need are affordable even for solo entrepreneurs and small businesses, and don't take long to put in place.

The best time to get your business protected is right at the start.

You'll be glad you did.

This guide takes you through the key legal documents you need and the important legal decisions you should make now.





## A Few Key Words to Learn

It's important to know the meaning of a few key terms in order to understand some of the primary legal considerations for startups.

### *Drag-Along Rights*

In the event of a proposed sale by a shareholder, drag-along rights give the selling shareholder the right to force the non-selling shareholders to also sell to the proposed purchaser. This is particularly important where the proposed purchaser will only complete if it gets 100% ownership. This is designed to ensure that major shareholders can't be blocked from exiting by minority shareholders.

### *Due diligence*

When someone is considering investing in your startup or buying your business from you, if they are prudent they will conduct investigations into all aspects of your business, including the legal terms of your key commercial contracts as well as your compliance with legal and regulatory requirements.

### *Employee options*

An employee option gives the employee the right to acquire a share in the company. This can be a right to purchase the share or receive the share for free. Usually, employee options only "vest" (ie, become exercisable) if certain specified performance targets are met. Remunerating employees with options is important both to conserve startup capital and align incentives.

### *Pre-Emption Rights*

Pre-emption rights, also called "rights of first refusal", are rights that entitle the existing shareholders to receive an offer of securities first before those securities can be offered



to third parties. This may relate to shares that one of the existing shareholders wants to sell, or new shares that the company proposes to issue to raise additional capital.

### *Tag-Along Rights*

In the event of a proposed sale by a shareholder, tag-along rights give the non-selling shareholders the right to sell alongside the selling shareholder (ie, the selling shareholder can't complete its sale unless the proposed purchaser also offers to buy out the tagging shareholders as well). This is designed to give minority shareholders the ability to sell into the same exit as a major shareholder.

### *Tax deferral*

Employees may receive employee options as part of their remuneration structure. Options have value and, unless the option plan is properly structured, the employee could be liable to pay income tax on the value of the options in the year in which they are granted. "Tax deferral" refers to deferring the payment of tax on the options until a later time (eg, when the company is sold).



## Shareholder's Agreement

### KEY QUESTIONS

- Who are the equity stakeholders?
- What are their voting rights?
- Who gets to appoint a director?
- How will important business decisions be approved?
- What restrictions should apply to selling shares and raising more equity capital?
- How will disputes be resolved?





## THE MOST IMPORTANT CONTRACT YOU'LL EVER SIGN

As soon as your startup has more than one owner, you need one of these, and this may turn out to be the most important contract you ever enter into. A proper Shareholders' Agreement will govern how important business decisions are made, how the company will raise further capital in the future and how the investors will ultimately exit – all crucial matters about which there should be clear agreement in advance.

Of particular importance will be pre-emption rights on new issues of securities, which help to prevent the investors from being diluted by future capital raisings, as well as pre-emption rights on transfers of securities to give the investors certainty about the particular individuals with whom they are going into business. Tag-along and drag-along rights can also prove to be crucial when one or more of the owners are seeking to exit the business.

Creating a shareholders' agreement for your startup will force you and your co-investors to sit down together and address these vital points upfront.

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## LEGAL HOUSEKEEPING: COMPANY SECRETARIAL

*"When the time comes to sell your business or raise further funding, potential purchasers and investors will undertake due diligence and ask to inspect the books of the company. Presenting them with a company register that is a shambles is not a good look, so doing your legal housekeeping now will prove to be worthwhile."*



Nobody likes paperwork, but certain legal record-keeping requirements are mandated for all companies by the Corporations Act 2001 (Cth). Failure to comply with these requirements can lead to ASIC (Australian Securities and Investments Commission) fines, as well as potential disputes amongst the investors.

All too often, startup founders are not aware of these legal obligations and the company's fundamental documents are thrown together with little thought, if any. This may cause serious issues down the track.

Important company secretarial documents include:

- register of members (ie, shareholders) and option holders;
- share certificates evidencing the shareholdings;
- application forms when investors subscribe for shares;
- transfer forms when shares are bought and sold;
- board resolutions approving all issues and transfer of shares and other key decisions of the company (eg, entering into major contracts, paying dividends, etc);
- consents to act as directors;
- company constitution; and power of attorney authorising key executives to sign documents on behalf of the company.





## KEY QUESTIONS

- Who are the directors, and have they been properly appointed?
- Do all investors have proper evidence of their shareholdings?
- Are the company's registers accurate?
- Are all ASIC filings up-to-date?
- Are all of the company's records in order?



## EMPLOYEE OPTION PLAN



An Employee Option Plan (otherwise referred to as an Employee Share Option Plan, ESOP, Employee Share Scheme or ESS) is an equity incentive arrangement that allows employees and consultants of a company to acquire shares in the company in the future at preferential prices.



### *Why adopt an Employee Option Plan?*

An Employee Option Plan enables the company to remunerate key staff members with equity. You may have heard the term “sweat equity”, which means paying employees for their work (ie, sweat) with equity incentives. There are 2 main reasons to do this:

- The company can hire key staff members and grow the team without needing to raise cash to pay their salaries.
- Giving key employees a stake in the ownership of the business aligns their incentives with those of the shareholders and helps to motivate them to work hard towards increasing the value of the business.

### *Proper structuring needed for tax deferral*

Where the price for purchasing the shares (ie, the exercise price of the options) is a discount to the current market price, without proper structuring, the employee may be taxed on the discount in the year in which the options are granted, even though the employee does not receive any money with which to pay that tax at that time. Your Employee Option Plan needs to be carefully structured to ensure that tax is deferred until a later time at, or closer to, a liquidity event in which the options or resulting shares are sold.

*"Giving key employees a stake in the ownership of the business aligns their incentives with those of the shareholders and helps to motivate them to work hard towards increasing the value of the business."*



## EMPLOYEE HANDBOOK

Every business needs a comprehensive set of employee policies and procedures. These work hand-in-hand with your employment contracts to define the company culture, set expectations and clarify the rules for all employees.

Adopting a proper Employee Handbook will help you to meet your legal obligations, enable managers to make reliable decisions and promote a culture of fairness. This can avoid disputes and grievances caused by confusion and inconsistencies and raises the level of professionalism of your business.

Your Employee Handbook needs to be customised to suit the particular environments in which your staff will be working and the tasks they will be performing (eg, food safety, manual handling, working outside, dress code, code of conduct, etc).



## EMPLOYMENT CONTRACT

Hiring your first employees will be one of the most exciting and significant steps for your startup. Choosing the right individuals to employ is, of course, most important, but all too often new companies bring in employees without putting a proper employment contract in place. That can lead to big problems for the business down the track.

In particular, it is absolutely vital that employees within the business are not able to lay claim personally to any of the company's valuable intellectual property. Confidentiality provisions will also be extremely important, as you will be exposing the inner workings of your business to your employees.

Also consider putting in place reasonable non-solicitation and non-compete provisions for staff who will have access to the company's proprietary know-how and key suppliers/customers.

Navigating through the minefield that is Australian employment law is a daunting task for any entrepreneur. A proper employment contract should be viewed as essential for every employee.





## THE IMPORTANCE OF CONFIDENTIALITY

You may be able to pique the interest of potential investors, joint venture partners and customers without giving away too much of your startup's confidential information, but their questions will inevitably become more probing and, sooner or later, you will need to delve into details that may be sensitive to your business.

As the saying goes, "I'd rather shake hands with an honest person than sign a contract with a crook". Trust is important in every relationship, including business relationships, but prudent business practice means putting in place the customary legal protections of a properly drafted confidentiality agreement (otherwise referred to as a "non-disclosure agreement" or "NDA") before disclosing your startup's valuable confidential information.

Requiring a confidentiality agreement before engaging in confidential discussions will not only help to protect you legally but will also help you to present as a prudent and professional businessperson to potential investors, joint venture partners and customers.

### KEY QUESTIONS

- What information is sensitive to the business?
- To whom will that information need to be disclosed?
- How will the confidentiality of that valuable information be protected?



## WEBSITE TERMS OF USE

Nowadays, every business needs a website, which means that every business needs a set of Website Terms of Use. Website usage terms lay down the rules for people using your website, including what conduct is prohibited. Importantly, they also include disclaimers and limitations of liability to protect you in case things go wrong.

Your website usage terms need to be customised to suit your business and the particular ways in which your website will be used. For example, if you sell products through your website, you will need provisions regarding pricing, payments, delivery and returns (if you are selling physical goods), refunds, etc. It is advisable to include a separate returns policy if you are selling physical goods.







## PRIVACY POLICY

Although small businesses (ie, with turnover less than \$3 million) are not mandated to include a Privacy Policy under the *Privacy Act 1988* (Cth), it is customary for all websites to include a Privacy Policy where personal information (eg, name, address, date of birth, credit card details, etc) may be provided by website users. Customers expect to see this when transacting online, so we suggest including a formal Privacy Policy alongside your Website Terms of Use.

## KEY QUESTIONS

- Is it merely a brochure website (ie, provides information only)?
- Does the website sell anything? If so, does it sell products and/or services?
- If products, are they physical goods needing postage, or digital goods (eg, mp3s, vi
- Does the website contain user-generated content (eg, comments, forum posts, etc).





## MORE INFORMATION

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