In line with global trends, Nigeria’s Information Technology (IT) sector has been witnessing increasing investment, growth, and innovation from both global and local stakeholders. Home grown tech start-ups are positioning themselves as increasing contributors to growing the Nigerian economy. They have also been active on the fund raising front as a necessary incidence of their growth journey.¹

According to Techpoint’s Nigerian Startup Funding Report Q2 2018 (Funding Report),² tech start-ups raised more than US$73 million in Q2 2018 with the Financial Services Industry (FSI) alone securing 75%. The Funding Report also noted that 21 foreign institutions invested in the Nigerian tech space in Q2 2018, whereas only 6 Nigerian firms participated.

Some of the investment is in part due to incubation hubs offering accelerator programs such as Co-Creation Hub (CcHUB), Lead Space, Passion Incubator, Nine, etc. The hubs’ business model is essentially supporting early start-ups by offering shared workspace, mentorship and exposure (including helping them with early structures and matchmaking with investors), in exchange for a part of the start-up's equity. This has resulted in success stories for many tech start-ups. For instance, according to the Impact Case Study on CcHub,³ 30 entities had been incubated with 40 at pre-incubation stage, as at October, 2016 and CcHub has supported other ventures including BudgIT, Wecyclers, Mamalette, GoMyWay, etc. Some of these ventures have gone ahead to gain significant recognition and raised seed capital in grants and investment.⁴

Despite these laudable strides in the investment landscape for Nigerian tech start-ups, there have also been instances where founders subsequently experience “sellers' remorse” for deals they had signed up for, which looked very good at the time of signing. There may be predatory investors intending to take advantage of the naiveté of young founders who are more focused on raising funds to enable the start-up’s continued existence and growth, than the terms of the deal and its

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¹ Examples of fundraising by Tech start-ups include: Konga (US$40 million in Series C funding round 2014), Paga (US$13 million in Series B funding round 2015), Andela (US$40 million in Series C funding round 2017), Flutterwave (US$10 million in Series A funding round in 2017), and civic tech entities such as BudgIT (US$5 million from Omidyar Network and Gates Foundation in grants).


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getting tech start ups investment ready: commercial & legal considerations for founders

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future implications for the start-up, its founders and even subsequent investors.

Sometimes, adequate provision might not have been made for dealing with issues that could arise where one of the founders decides to exit and to pursue another (not necessarily competing), venture. This underscores the need for institutionalised corporate governance from the 'get go', to obviate resultant existential challenges to the original start-up, especially where the business strategy of the startup is built around the exiting founder.

However, there may be agreed terms of non-compete, non-circumvention, confidentiality etc. in the agreements signed by founders, this would ensure that where a co-founder exits the business, he is estopped from setting up a competing entity. Along with injection of capital, these investments often herald changes in the management teams and sometimes control of these start-ups; transition from founder led to strong leadership team is an agreed objective.

This article therefore seeks to highlight key legal and commercial issues in organizing tech start-ups to get them and their founders in optimal position to negotiate win-win deals with investors. An increased (positive) deal outlook is anticipated as more entrepreneurs focus on the tech space given the exponential returns that successful ventures can bring, as well as the business landscape transformational changes attendant on the start-ups' service delivery.

No less important is the national imperative for Nigeria's move from an extractive to a knowledge economy to competitiveness and capture of as much future global wealth as possible. Given that tech start-ups impact their respective sectors, and the 'transferability' of the points discussed herein, they can also be applicable to non-tech start-ups.

housekeeping – securing investments in tech start-ups

As noted earlier, the Nigerian tech ecosystem has witnessed many entrants resolutely working to grow their ideas with the expectation of seed capital to spur growth. Likely there are other start-ups that were funded but whose deals were not captured (for example because of low visibility or deal values) in the Funding Report. Usually, investors require that founders present a Minimum Viable Product (MVP) or proof of concepts attesting that the business idea has been tested and is commercially viable. Upon the development of the MVP, investors may thereafter be willing to invest and take equity in the business.

Presumably, founders need to set up a vehicle through which the business will be carried out. The most common vehicle is the private limited liability company (incorporated under the **Companies and Allied Matters Act (CAMA)**

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5 Cap. C20, Laws of the Federation of Nigeria (LFN), 2004. Section 567 CAMA defines a company to mean “a company formed and registered under this Act...” whilst section 38(1) CAMA stipulates “… every company shall, for the furtherance of its authorised business or objects, have all the powers of a natural person of full capacity.” The Court of Appeal in P.A.I.S.C Ltd v. Jupees Impex Co. Ltd [2016] 3 NWLR (Pt. 1182), 441 at 463 elaborated on this definition to hold that a company is a union or association of persons carrying on a commercial or industrial enterprise. In our view, even if the business started as a partnership (i.e. business name under **Part B CAMA**) for reasons of easier compliance and lower maintenance costs, the business may need to transform into a company at the point of entry of investors. This is because unless specialised partnership vehicles are used (such as Limited Partnerships or Limited Liability Partnerships (for instance, under **Lagos State Limited Liability Partnership Law 2009**)) where only the general partner's liability is unlimited), all partners are fully liable for the debts of the partnership, debts of the partnership.
assets and liabilities. Its assets are not of its shareholders; the measure of their respective interest in the company being the quantum of their shares. These points are well enshrined in sections 37 and 38(1) CAMA and the locus classicus of Salomon v. Salomon\(^6\) which has been variously endorsed in Nigeria.

Clearly, the use of a corporate toga is apposite to mitigate the operational risks of the business particularly the financial risk as shareholders' liability is generally limited to the amount unpaid on their shares.\(^7\) Accordingly, founders will set up the company and allocate shares to themselves in the proportion of their respective interests. Shares are units of a company's authorised capital which defines the interest of members of the company.\(^8\)

**Governance: Founders’ Agreements (FAs) and Shareholders’ Agreements (SHAs)**

During the development of an IT product, founders could expend time and resources for years before launching same. During this 'waiting period', founders are expected to enter into FAs to define their rights, relationships and responsibilities. This includes what becomes of parties pre-incorporation resources if a party decides to pull-out before the product is launched. FAs are particularly important as the CAC no longer allows elaborate Articles and Memorandum of Association (Memart).

It is often the case that there are no formal terms of engagement during the pre-formation stage of the company. Usually, the founders who could be friends/family/professional colleagues, may not see the need to have a concretized arrangement in place to guide their relationship. The proverbial oral agreement or contract on a restaurant napkin, cemented with a friendly handshake, comes to mind. Subsequently, divergent understanding of what the parties envisaged or agreed especially with respect to respective entitlements and under what conditions could lead to disputes and 'breakups', sometimes with grave implications for the business.

Facebook, a US$493 billion company, was not spared of such disputes, exemplifying the importance of having documented understandings in place; the greater the potential for success of the venture, the more imperative it is that contracts be signed by the parties.\(^9\) These disputes could have been avoided if parties had entered into an FA as both cases centred on their contribution in the formation of the company. The FAs would have contained exit clauses and adequate compensation agreements.

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\(^6\) (1897) AC 22

\(^7\) There are however exceptions in cases of manifest fraud, where the veil of incorporation will be lifted and directors are personally held liable for the acts of the company, sections 290, 316 and 548(4) CAMA. In FDB Financial Services Ltd v. Adesola (2000) 8 NWLR (Pt 668) 70, the Court of Appeal stated that "... even if fraud and/or illegality are discernible in the conduct of the affairs of the company, this in itself does not disregard the company's separate personality since the court often impose liability on the company as well...."

\(^8\) In line with recent initiatives on the ease of doing business by the Presidential Enabling Business Environment Council (PEBEC), incorporation process and requirements have been streamlined towards improved service delivery timelines by CAC.

\(^9\) Facebook has faced various claims of co-ownership from many people for example Edward Savarin who claimed he had invested funds during Facebook's development phase. Similarly, Facebook had to settle the Winklevoss brothers with US$65 million. See Ben Parr, 'Facebook Complicated Ownership History Explained', Mashable April 13, 2011: <https://mashable.com/2011/04/13/facebooks-complicated-ownership-history-explained/> (accessed 25.7.2018)
plan for exiting party. Such could have prevented the instability in the company’s share price during the hollowing negotiation process due to uncertainties it creates.

Unlike the FA, the SHAs typically come later in time when founders are ready to incorporate an entity and admit other shareholders. The SHA which sometimes subsumes the FA (because its terms supersedes those of the FA, or the FA is merged with the SHA) makes relevant provision for governance structure of the company (board composition, control and governance, etc.) upon incorporation. In the same vein, it also provides for the manner of ownership, valuation and disposal of shares, financing of the company, dividend policy, deadlock situation, amongst others.

However, it must be noted that these are internal documents and are not required to be filed at the CAC.

In *Societe Generale Favouriser Le Development Du Commerce Et De L’Industrie En France (S.G.F) v. Societe Generale Bank (Nig.) Limited*, the Supreme Court pronouncing on the legality of pre-incorporation contracts held that Article 11 of the FA which provided for arbitration was in line with *sections 72(1), 624(1), 626 and 651(2) CAMA*. It is therefore prescient that contracts such as FAs, SHAs and other pre-incorporation contracts must be ratified by the company upon incorporation so as to be bound. Otherwise, the parties purporting to contract on behalf of the company would be personally bound by it.

One of the main considerations in *FA* and *SHA* is the provision on anti-dilution. Typically, dilution occurs where the company desires to raise capital through equity financing and need to issue shares to the new investors which may affect, reduce or ‘dilute’ the *pro rata* stake of existing shareholders if the latter does not participate in the current financing round. It is therefore essential to device mechanisms that shield the founders from dilution beyond set thresholds. This could be either through full ratchet anti-dilution or weighted average anti-dilution.

From the investor’s standpoint, risk mitigation is of utmost importance. Therefore, mechanisms such as lock-in period for founders, liquidity preference, right of pre-emption, etc. are essential. Whilst these should all be contained in the *Investment/Subscription Agreement (ISA)* and the SHA, the exact parameters could be dependent on the risk appetite of the investor. There may be a difference in investment outlook of, say for instance, a Private Equity (PE)/Institutional investor – which invests for its limited

References:

10. [1997] 4 NWLR (Pt.497), 8
11. The Court stated at p.28 that: “…the common law position that a company is not bound by a pre-incorporation contract has now changed in Nigeria by virtue of section 72(1) [CAMA] which makes it possible for pre-incorporation contracts to be ratified by a company after its incorporation and thereby making the company bound by it and entitling it to the benefit thereof…”
13. There are instances of co-founders exiting too early only to realize that they had lost out based on the long term fortune of the company. Examples are: Ronald Wayne who sold his 10% stake in Apple to other co-founders after 12 days of Apple for US$800 in 1976; Andrew Mason, the former CEO of Groupon, had sold his shares in 2011 after he was removed as CEO worth US$200 million, Groupon is worth more than US$2.72 billion, August, 2018; etc. See, Dan Ketchum, *Founders who Cashed Out Too Early and Missed a Big Payout*, *GoBankingRates*, 10 January 2018: [https://www.gobankingrates.com/net-worth/business-people/Founders-cashed-out-early-missed-big-payout/](https://www.gobankingrates.com/net-worth/business-people/Founders-cashed-out-early-missed-big-payout/)
14. Under the full ratchet anti-dilution option, shares sold by the company after issuing initial shares applies the lowest price as option price for existing shareholders through convertible pricing. Thereby allowing them to maintain their ownership percentage in the company should the company create additional offerings. On the other hand, the weighted average anti-dilution option adjusts the rate at which preferred stock is converted into common stock based on; the amount of money previously raised by the company, the price per share at which it was raised, the amount of money being raised by the company in subsequent dilutive financing, and the price per share at which such new financing is being raised. Although these mechanisms prevent dilution of a shareholder, care must be taken to ensure that it does not stiffen subsequent financing rounds in the company. See *Investopedia*, *‘Full Ratchet Anti-Dilution’,* [https://www.investopedia.com/terms/f/fullratchet.asp](https://www.investopedia.com/terms/f/fullratchet.asp) (last accessed 13.08.2018)
partners with a time specific exit plan/strategy and a conventional/regular investor whose primary aim may be to stick with the tech start-up for the long term in its operations, growth and value creation journey.

It is also important to include tag along and drag along clauses which protects the interest of the minority and majority shareholder(s) in the SHA. These come to play when relevant parties are divesting their shares in the company or have received offers to divest. Tag along clauses ensures that where the majority shareholder intends to transfer her interests (shares) in the company, the minority shareholders may also benefit from such transfer by offering their shares to the same investor on the same terms as that of the majority shareholder.

On the other hand, drag along clauses are used to ensure that the minority shareholder does not clog the transaction where a majority shareholder intends to transfer an investor.

Building Corporate Assets - Intellectual and Industrial Property (IIP) Rights

Upon the incorporation of the company, founders may take steps to protect their product by obtaining IIP rights through Patent, Copyright, Trademark and Designs where applicable. Patent is the right to own and economically exploit an invention. Section 2(1) Patents and Designs Act (PDA), provides that: “...the right to a patent in respect of an invention is vested in the statutory inventor, that is to say, the person who, whether or not he is the true inventor, is the first to file, or validly to claim a foreign priority for, a patent application in respect of the invention.” Similarly, section 12 PDA reads: “Any combination of lines or colour or both, and any three-dimensional form, whether or not associated with colours, is an industrial design, if it is intended by the creator to be used as a model or pattern to be multiplied by industrial process and is not intended solely to obtain a technical result.”

It is also instructive to note that sections 5 and 6, Trade Marks Act (TMA), protects the proprietor of a registered mark and give such proprietor the right to exclusively use the mark in relation to goods. This right also include the right to prevent anyone from using similar or identical trade mark which is likely to deceive or cause confusion in the course of trade. Whilst the Merchandise Marks Act, prohibits and criminalizes the counterfeiting of registered trademarks by unauthorised persons; and the importation and sale of counterfeit goods.

15 Cap. P2 LFN, 2004
16 Also, the Copyright Act (CA) Cap. C28 LFN, 2004 does not provide an express definition of ‘copyright’, one learned author defined it to mean “…the exclusive right to control the doing in Nigeria of certain acts in relation to the work in which the rights subsist.” Works such as: literary, musical, artistic, cinematograph, sound recordings and broadcast are protected by virtue of section 1 CA.
17 Cap. T13 LFN 2004
18 Cap. M10 LFN 2004
19 See, Seven-Up Company & Anor. v. Warri Bottling Company Limited (1998) F.H.C.L 183, where the Plaintiffs claimed that they owned three registered marks namely “Seven Up”; “7-Up” and “Up” but they saw advertisement by the defendants in the Daily Times for a product referred to as “Thumbs-Up” which is similar to their product and which might cause confusion in the market. The Court held for the Plaintiff, having considered: the two words and examined them both by their look and their sound; the goods to which they are to be applied; the nature and kind of customers who would likely to buy these goods; all the surrounding circumstances of the case and what is likely to happen if each of those trademarks is used in a normal way as a trade mark for the goods of the respective owners of the marks.
In the tech space, incidents of cybersquatting are rife. In 2014, Konga reportedly threatened to sue Rocket Internet (owners of Jumia) for allegedly registering its domain name in 10 African countries.20 Recently, the FG was confronted with this challenge after unveiling Nigeria Air at the Farnborough International Airshow, London. The domain names: NigeriaAir.ng and NigeriaAir.com.ng were registered by an individual who put same up for sale at US$66,489 each. Also, NigeriaAir.com and NigeriaAir.ng were equally registered at about the same time by another person.21

In recent anecdotal memory, Vodacom had similar experience during its tie up at the CAC but realised that someone else had used a similar name, hence the parties resorted to the use of VMobile for the post Econet operation.

Section 25 Cybercrimes (Prohibition, Prevention, etc.) Act22 prohibits cybersquatting with penal sanctions. However, for the provision to take effect, the name, business name, trademark or domain name, etc. must be owned or be in use by any individual, body corporate or belonging to any of the Federal, State or Local Governments. This means scope for relief for private parties may be limited. In the same vein, the CAC could refuse to register a company if the proposed name of such company is similar or likely to be confused with that of an existing company; section 30(1) CAMA.

Undoubtedly, IIP rights have proven to be a significant part of tech companies in recent years evidenced by the volume of transactions in the tech space.23 For example, in 2011 Nortel sold its patents to a consortium of Apple, RIM, EMC, Ericsson, and Sony for US$4.5 billion,24 Google acquired Motorola Mobility with its patents for US$12.5 billion, amongst other deals.

These incorporeal assets often turn out to be most significant to the company in the long run. It is therefore prescient to consider the long term business objectives of founders before deciding the 'entity' to hold such rights. For instance, if the invention underlining the company's product was created by one of the founders, the inventor-founder could register the IIP rights of the invention in his own name and thereafter grant exclusive or non-exclusive license of same to the company for a specific term in consideration for royalties.

Where this is done, the inventor-
The employee share scheme arrangement could be:

- **company share option scheme**
  
  The company grants selected employees a right (an ‘option’) to acquire shares at some future date at a price fixed at the date the option is granted;  

- **savings-related share options scheme**
  
  Employees enter a savings contract with a bank or building society nominated by the company for a specific duration with the intention that the proceeds of the savings plus any bonus paid by the bank or building society will be used to purchase the company’s shares at an option price fixed at the time of entering into the contract;  

- **share incentive plan**
  
  The company establishes a trust scheme to hold the allotted shares for a certain period and the shares vest on the employees’ overtime after meeting the conditions in its rules;  


In *Adamson v. Kemsworthy*, an assistant engineer who was employed to design linings for colliery tunnels was sent at his own request to a particular colliery and in consequence produced an inventive solution to its problem. The court held that the arrangement of the visit placed him under a duty to make over the patent. Conversely, in *Greater Glasgow Health Board’s Application*, a hospital registrar employed by a health authority to treat patients was held to be under no duty to his employer to devise improvements to ophthalmic equipment. Contracts with such programmers/developers would also include confidentiality, non-circumvention and non-compete clauses.

In Nigeria, whilst *section 159 CAMA* expressly prohibits financial assistance by companies for the acquisition of their own shares, *section 159(3)(b) and (c) CAMA* creates exceptions with regard to employee share ownership schemes. Similarly, sweat equity arrangements could also be made with employees as a form of compensation.

Under this arrangement, the compensation (payment) for work done by the employee will be in the form of the company’s shares. It is also a form of share ownership scheme and it is apposite that its parameters be well defined.

Having employee shares pool will
be instrumental in attracting and retaining key talents (e.g. programmers) in the start-up. Usually, the shares will vest over a period of time considering the input of the employees after meeting certain Key Performance Indicators (KPIs). In the event of exit of an employee, the management of the scheme reserves the right to purchase such shares at current valuation and retain same in the option pool. However, in designing the rules for the scheme, care must be taken to ensure that it does not inhibit investment in the company. Thus, the input of professional advisors will always be expedient in designing optimal, company bespoke schemes.

Optimal Compliance Status Issues

To attract investment, a tech start-up must 'undress' for potential investors to conduct due diligence (covering legal tax and regulatory compliance status/risks, financial condition, employee numbers and practices, etc.) on the company. This enable the investor have informed view about the company's potential vis a vis any potential risk exposures. It is therefore important that the company have in place from inception or as early as possible, best in class operational framework to ensure that investors' DD will find it in a positive state.

Thus, the company as well as founders will be able to attract desired valuations for any stake they want to sell.

Does the company have 'unfair' long term contracts with suppliers, financiers, joint venture partners that will make it lose more value as the business performs better? If there are major issues, such as huge contingent liabilities from litigation, regulatory fines and penalties or substantial back taxes, investors would factor these into their offering prices, if they choose to proceed. However, if the situation is dire enough or the parties cannot agree on purchase price, investors are likely to 'take a walk'.

This could be discouraging and means that the corporate efforts and resources expended in trying to get a deal done goes to waste. However, the company can put a positive spin on this by working on and regularizing all the areas of concern towards making the company more attractive for the next potential investor. Even the prior failed deal's negotiation experience can be helpful in closing the next one on a more favourable note. It bears repetition that for the start-up to be taken seriously, it must institutionalise its operating processes as a company and definitely not operate out of the fringes, as an informal sector player.

As another example, the investor may want to see that the start-up's privacy policy is in line with global best practices. It must also comply with local requirements particularly the National Information Systems and Network Security Standards & Guidelines, 2013 issued by the National Information Technology Development Agency (NITDA) pursuant to sections 6 and 17, NITDA Act. 32

30 In the US case of Beam v. HSBC Bank USA, et al., No. 02-CV-0682 (W.D.N.Y.), the Complainant alleged that in September 1999, the fiduciaries of the Azon ESOP caused the plan to overpay for Azon stock purchased from certain directors and other insiders for more than fair market value and other irregularities, leading to Azon's bankruptcy. The Defendants eventually agreed to settle the lawsuit for US$9.35 million.


32 Cap. N156 LFN, 2004. The growing privacy concern around the globe has also necessitated an additional level of compliance under the European Union General Data Protection Regulation (EU GDPR) which became effective in May, 2018 with extra territorial application outside the EU. It is therefore prescient for data processing start-ups (whose data harvesting capabilities are not restricted to a particular jurisdiction) to take steps to comply with the provisions of the GDPR to avoid exposure to fine and sanctions. All other compliance requirements are sector based depending on the sector of operation of the tech start-up i.e. Banking (CBN), Insurance (NAICOM), Telecoms (NCC), etc.
Conclusion

It is gratifying that many Nigerian tech start-ups continue to position themselves for seed or expansion funding from foreign and local investors. Many (eTranzact, Courteville, Interswitch, MainOne, Andela, Flutterwave, etc.) have indeed not only survived start-up phase but are poised on regional expansion or even attaining Africa-wide footprint. Whether in new markets or at home in Nigeria, it is critical that they focus on downside protection and optimising upsides; that they do not lose sight of protecting themselves against any unforeseen contingencies through creative use of appropriate legal and commercial mechanisms.

The presence of 'predatory' investors that could take advantage of the naiveté of young founders – who may be presumed too preoccupied with raising funds to increase their operations and market reach to pay attention to commercial terms could result in unfair deals for such founders. Also, start-ups could be targeted for acquisition or mergers to consolidate the points of the acquirer in the market, creating a seaming monopoly.

Given the long term aspirations of founders, and oftentimes the desire to build globally relevant companies, it must be recognised that these feats can only be achieved where an enduring structure is put in place with well thought out succession plan. Thus, tech start-ups must position themselves well for investment to enable them continue their growth trajectory and deliver value for stakeholders, especially founders and investors. At all times they must be better able to pursue all relevant landscape opportunities, etc.

It is almost a given that start-ups will require growth funding, the earlier they prime themselves for this, the better. Should they require public funding, they would need to meet the requisite capital market requirements of Initial Public Offerings (IPO) and oversight of regulators such as the Securities and Exchange Commission (SEC) and the Nigeria Stock Exchange (NSE). Given the significant liquidity event represents for founders, and even better positioning for the companies, these issues are not insignificant and are worthy of intense focus.

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