LS Africa Presents: Venture Voices

Episode 3:
Legal Challenges Part 1 – Setting Up Your Startup for Success

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Deangeor Chin: Welcome to LS Africa Presents Venture Voices. Before we jump in, if you would like to learn more about our Africa practice and some of our upcoming events, visit lowenstein.com and subscribe to our mailing list to stay in the know. I am Deangeor Chin. And today my Lowenstein colleagues, Rossie Turman, Raquel Smith, and Tolulope Adetayo and I will discuss some of the legal challenges we see in the startup space in Africa. We'll provide examples of common legal issues and potential solutions.

It's worth noting that we will not be focusing on how to source investments or startup operational issues as those topics will be covered with our guest investors and founders and future episodes. Instead, we'll focus our attention on legal considerations that frequently arise in the VC ecosystem.

This will be part one of a three-episode series discussing legal challenges for Africa startups. Today we'll talk about the best way to get your startup, or a high growth entity set up. With that said, let's jump in.

Tolulope Adetayo: Thanks Deangeor. As we may know, one of the crucial steps in the life of any startup is entity formation, and we have clients often come to us for assistance with setting up their liquid shares and some of the organizational structure in the United States. And one state that often comes to mind is Delaware. And the question that follows will be why African startups plug into Delaware for their legal startup?

I mean for starters the Delaware legal system is renowned for being very business friendly, especially with specialized courts of chancery, which mean faster resolutions of conflicts, and also this attempt in terms of precedent and it also provides clarity on corporate matters. But more importantly, what truly makes Delaware appealing, especially for asset protection and attracting investment?

Rossie Turman: Well, as you know, I wrote an article I think in TechCabal last year, 2023 about this topic. And I would say there's two issues to focus on. First of all, investors like the lack of friction of investing in Delaware. And what I mean by that is they have their own documents, methods, et cetera, that are tried and true on how they invest in Delaware to get the rights that they want in the entities they're investing in. If they invest anywhere else, they have to consult with people like us, their lawyers, to figure

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out how to replicate those rights. That creates more friction if you're trying to invest fast and it also creates more cost. So you don't see people going to be creative if it's a smaller amount they're investing or if it's something that needs to be done rapidly. So if I'm an investor, that's one of my considerations.

The other consideration is if I am someone trying to raise money, is most investors globally know how to invest in Delaware. That's not the same for other jurisdictions around the world. They may know how to invest through Dubai but not know how to do London. They may know how to do Singapore, but not Dubai. But most investors that are global investors do know how to get a Delaware investment placed, whether it's through a side vehicle or directly in. And so that's the other thing. You have a much bigger capital group that you can raise from.

Deangeor Chin: It seems like to some extent, comfort is an important aspect with investing, and I think Delaware in many cases provides that comfort and flexibility.

Raquel Smith: For some investors, their LPs require them to invest in Delaware or United States incorporated entities. So for a lot of investors, whether they be institutional or funds, they don't have a choice. They can't invest in a company until they have some type of US entity that they can deposit funds into. So, I guess just to take a bit of a step back, it feels like when we ask the question, why are companies flocking to Delaware? A large part of it is because they have to, right? If they're interested in raising capital in the US it's dictated by where their investors are going to be comfortable putting those funds in. So I think that comfort of investors and chasing that capital, that goes hand in hand.

Rossie Turman: I think that's definitely true late stage for sure, the larger investors, but I think even like Y Combinator and Techstars, at least last time I checked, they were requiring companies that they were going to invest in to form in Delaware as well. And I think that goes to that comfort level.

One thing on the comfort, let's be clear, there's a lot of documentation that goes into investing in a company, and there's particular rights that I may want in that company as an investor, or rights I may want vis-a-vis the investor as a founder. And those tend to be much more well-worn in how courts will interpret those rights, or the language in those documents in Delaware. And that's not because of the ECVC market, it's because for years, corporations from all over the world have used Delaware. And so a lot of these shareholder rights issues have been fully flushed out in that jurisdiction where they're not as nearly well flushed out in other jurisdictions. And you have judges who are very sophisticated in how they'll interpret this because it's so well worn, Tolulope.

Tolulope Adetayo: No, absolutely. I think one thing that is very common with what everyone has said is pretty much about familiarity and comfort, and I definitely agree with that. Moving to Delaware, it's a very strategic move that seems to offer a lot of advantages for these startups as they navigate a complexity of scaling globally. But also, it's not just about setting up your shop, it's about setting up yourself for success.

So just going off a little bit of that in terms of fundraising globally and especially when it comes to startup valuation, what do you think... I'm throwing this up to the whole group anyway, and also just to mention ECVC, we hear that as we continue with this, our conversation means emerging companies and venture capital, that's what it means for our listeners listening.

But going back to my point, how significant is the decision of where to position your assets influence a startup valuation? Especially in terms of setting yourself up for

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success in global fundraising efforts. Are there any strategic moves or insight that you've seen working with all the startups over the years?

Raquel Smith: I think it goes along with the conversation I think that we were just having about where investors want to put their money in. And I think this is something that we actually come across quite a bit in our practice, which is where in the structure would the Delaware entity fall in? So for companies, when they come to us and we're having these initial conversations, one of the things that they're usually asking is if they have an operating company that's already set up in a country in Africa, their question is, if I need to put in some type of Delaware entity, does it need to be a holding company? Can it be a subsidiary? Where does that fall in? Does that matter from an investor standpoint?

And I think there's definitely a lot that comes down to valuation, where the assets are held, because for the most part investors will want to see it as a holding company because then they're assured that they're investing into the business as a whole and they have access to all of the assets of the company, whether that be inventory, or IP, or whatever the case may be.

Rossie Turman: Breaking that down a little bit more, if I'm buying a house, it matters to me whether or not the furniture in the house is owned by you as well. It matters to me whether or not the ground underneath it is owned by you as well. And so what I'm getting value to the value of the house, I'm looking at everything that flows down from it. And so when I'm looking at a company, I'm only going to give value to things that are either in the company, I'm investing in, the actual entity, or that are below that entity, owned by that entity. And then when I'm looking at what's owned by the entity, it matters to me whether it's a hundred percent owned, or not. And in my experience, if it's not a hundred percent owned or setting aside local ownership law, well, let me say this, it's not a hundred percent owned. It actually confuses the story. It's going to be hard to get investment.

Now, the one answer that typically works well is that there are local law requirements requiring local content in terms of investors. That's a quick explanation, and those who invest globally understand that that happened. And so that will change their valuation, but it won't change their perspective and that I don't want to deal with that. You have a bunch of JVs underneath the entity they're investing in, that gets very confusing and it's going to be hard to get investment, in my experience.

Tolulope Adetayo: Yeah, that's very useful actually. So just going off that a little bit more, one step above that. It seems like it's a very complex situation, especially managing your IPs and also more importantly where you're trying to scale globally. So in terms of intellectual property, what are the essentials that you think, in your opinion, that are important for startups to ensure that their IP remains both protected and also attractive to international investors?

Deangeor Chin: I would say intellectual property assignments are probably pretty important to protect the company despite changes in management, or founders, or employees. And these are agreements that essentially require whoever assigns them, whether they be the founder or employees, to assign their rights in any IP created for the company to the company to ensure that the company has ownership of that IP moving forward and has the rights to use that IP.

I've seen some examples where founders who started work for a company initially, maybe they break ties later on, and there is some kind of dispute with regards to the work that was done, whether that founder can take that work and start another company, or whether it is the property of the initial venture that they created. So I do

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think it's important in protecting your IP to consider those when you are hiring and starting up.

Rossie Turman: Yeah, this dovetails well with your earlier question about ownership, right? The general rule should be that the messier it is, the more I talk about who owns what, the more it's going to be a challenge to valuation. The more I have to explain how the legal ownership is there, the more it's going to be a challenge to valuation. So what I really want to do when I'm buying something, I want to know that you own it first of all. And that you own it, I prefer that you own it rather than you licensed it. If it's a license and that goes on into perpetuity, and then if it's a license that is only to you and doesn't include licensing other people, that's more valuable to me as well.

To Deangeor's point, then on the belt and suspenders in the cleanup, I want to know that everybody, whoever worked for you is signed while I'm going on the work for hire theory. In other words that they worked for you; they were doing it as hired out by you. I also want to see that they've actually signed some document. That's a theory that has to be explained, may have to be argued. I want to see that they actually signed away any rights they may have to the company. That makes me feel even better that the company actually owns it and someone won't show up, Rossie won't show up later and be like, "Well, actually I invented that and it's mine." That's what people are trying to get away from, is any discrepancies around who owns what, and only then will they give you full value for it.

Tolulope Adetayo: Absolutely. Yeah. I think one key takeaway is just make sure you get yourself a lawyer. I think it's very important, especially starting out, just make you to get yourself lawyer.

Rossie Turman: That may be self-aggrandizing, but yes, you do need to do that.

Tolulope Adetayo: Absolutely. But just remaining at that particular point.

Rossie Turman: One thing, Tolulope, on that point though, obviously, but get a good lawyer.

Tolulope Adetayo: Yes, I should have said that, good lawyer.

Rossie Turman: Quality does matter here. It's like don't go to a bad restaurant. It's not just go to a restaurant, go to a good restaurant if you're going to eat the food.

Tolulope Adetayo: Quickly. Do we have any tales from the trenches, like any sort of standout stories or lessons learned from startups that you have worked with that you've had that faced any orders, especially with Delaware setup or IP assignment?

Rossie Turman: Yeah, I'll tell you what the first issue is, I'll tell everyone who's going to form a company. Let's say that you're a company and you're organized in Tanzania and you've got three initial investors, and I think you might want to raise money globally. But first you think you've got these seven investors in Tanzania and you want to add them. I would say don't add them to the Tanzania entity, add them to the Delaware entity. Why? Because when you do the flip, you're going to have to move all the current investors up to Delaware. And the more entities you have in or people you have in, just the harder that is to do. They all have to sign off on it.

And so if you think you're going to do a global investment, manage your cap table. If you're going to raise global investment, manage your cap table to as few people as possible prior to doing that because it becomes very challenging. Everyone has their own tax issues, everyone has their, "I need to understand this. What's going to happen if I own a piece of an entity in the US?". And it just goes on. It just gets more

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complex just by the number of people involved. So if you think that to scale you need international investors, form your entity sooner rather than later.

Deangeor Chin: Yeah. And what I'm hearing from you Rossie is try to be as forward thinking as you can with understanding the restrictions around costs and things like that, but it'll save you a lot of heartache, and time, and money on the backend if you're able to be a little more strategic at the outset as to how you're setting things up, where you're setting things up, what makes sense, so you don't have to kind of continue to repeat the same work over and over again.

Tolulope Adetayo: Absolutely. Just staying focused on be very futuristic.

Considering the rapid evolution of African tech landscape, what do you think startups should be thinking about now to prepare for the future, and especially in the light of the Corporate Transparency Act and all these other laws that affect both in and outside startups, what do you think these startups should be thinking about to prepare for the future?

Raquel Smith: I guess one thing that came to mind is just thinking about some of the issues that different countries, and jurisdictions, and regions are facing with respect to currency and how that impacts the way they're able to raise capital or do business. Another reason to think about incorporating or having an entity in the United States is to be able to scale into or gain exposure in the US markets. So that's something that I think is being discussed quite a bit right now, especially with a lot of the volatility I think that's around the continent. So being able to have a US entity that you're operating through might be a really beneficial choice to make.

Tolulope Adetayo: Absolutely.

Rossie Turman: So couple things since we're finance lawyers, most of us, and we're also lawyers. So the CTA, let's go back to that, the Corporate Transparency Act. That's an act that just got passed here in the US which is they really want to know who owns the entity. And so one of the anxieties that's going be with some African investors who maybe don't want to be known, the CTA is really intended to know. That's a global push. Frankly, it's a global push that's for global taxation issues, and so that's going to make it more challenging for a lot of people who are trying to hide and it's meant to do that. And so we should just be honest about that. So know who your investor base is because that's going to create some challenges for you when you try to reach out to other investors down the road.

Now, you can obviously use vehicles for them to invest through and stuff like that, but it's really intended to look through that stuff. And so if you have individuals who really don't want to be known as investors, they need to be very thoughtful about how they invest in your entity. If their accounting may be able to go out for global investment, the CTA is looking to block that. That's a whole other podcast to talk about, corporate transparency globally, and tax evasion and stuff like that. We won't do that now.

But the other thing is the trend for the next 7 to 10 years of my experiences is on Africa that's going to benefit it is this FX piece that Raquel kind of touched on. So the idea really is that most African countries, most not all, have weak balance sheets. In other words, what they did is they borrowed a lot of money on the global bond markets recently, and many of them are having to restructure. I think of Ghana for example, as opposed to maybe say Gabon who paid theirs off recently. So you have these weak balance sheets. That's an inflation driving occurrence.

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You also have most African countries import a lot more than they export, so their balance or trade balances is off. That also is an inflation driving factor, and those are macro issues that no small startup is going to change soon, and most governments won't be able to change soon either. What that means is the inflation in Africa is likely to outpace the inflation in the US, and if inflation in Africa is an outpacing inflation in the US, just me investing a dollar today in that African jurisdiction means it'll be worth more tomorrow on inflation alone.

But it also does something else. It means that that's a value add in one way. It also does something else though if there are actually an African entity that is servicing US corporates, which is that you're paying for the services in a depreciating asset, as in the cost of rands, or in shillings or whatever currency you're doing, for your worker, which is competitive in that particular jurisdiction, continues to get cheaper versus the pricing to whoever you're supplying. And so that ethics trade alone should drive value for certain startups. I hope that made sense.

Tolulope Adetayo: Absolutely. Absolutely.

Rossie Turman: That will be a macro trend though for like 7 to 10 years. It's not going to get... There's no real practical way for it to be flipped. IMF or World Bank interventions takes a while to unwind that.

Raquel Smith: Right. Thanks Rossie. We hope that you found today's discussion informative and that it provided you with some food for thought when considering some of the legal challenges that African startups face.

This episode is intended to be a high-level overview and is by no means an exhaustive discussion.

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