

What start-ups and investors should know

Osman Ertürk Özel outlines prominent legal aspects of start-ups in the light of his experiences at Ankara Technology Development Center

Founders of new startups often spend a great deal of their time trying to enlarge their business project by improving and marketing their product or service, together with hiring valuable employees, attracting potential investors and making them excited enough regarding their business plan to convince for a sufficient amount of investment. Entrepreneurs found ways to achieve the aforementioned goals along with upgrading an idea to a billion-dollar valuation company. Nevertheless, it is no surprise that many major matters are being put aside by the founders, especially at the early stages of a project, on the opinion that they are not critical, since they intend to move things as quickly as possible. Adding cost concerns on top of that will lead them not to receive any legal support or financial consultancy services.

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As a result of such pressures, all the crucial legal documents are signed with poor judgement calls and without being properly reviewed in terms of relevant laws and regulations. However, it must be noted that difficulties may occur later down the road, in cases where legal, regulatory and tax issues are not dealt with at the beginning of the startup journey. Such issues could also create a disadvantageous stance in the eyes of an investor, especially during the establishment of an effective exit strategy. Therefore, in order to eliminate any judicial financial drawbacks, necessary legal actions should be taken at the right stage to preserve both the founders and investors.

At Özel Attorney Consultancy, our office provides consultancy services for both international and domestic clients operating in the technology ecosystem. Participants of this ecosystem rise day by day, however, there are inadequacies in supporting the sector. As to promote the ecosystem, Ankara Technology Development Centre (Ankara TEKMER) has started its operations, which are financially

supported by the Small and Medium Industry Development Organisation (KOSGEB) and aims to bring both startups and investors together. Startups that will carry out R&D activities at Ankara TEKMER will bear lower costs and liabilities in return for proving that the R&D operations are gradually continuing. Based on our experiences as legal representatives of Ankara TEKMER, an outline is provided below for both startups and investors on what to pay attention to in the investment process.

1. WHICH LEGAL ENTITY IS SUITABLE FOR A STARTUP BUSINESS?

When ideas and operations start to mature, it would be wise to establish a company for two reasons. First of all, ensuring a corporate veil is a must in order to protect shareholders. Secondly,

considering that ideas are subject to trademark ownership and patents, founders would prefer to register them under a company's name. With that respect, unlimited liability companies are out of the question for entrepreneurs as they pose great risks to shareholders. Therefore, either limited liability companies or joint stock companies are more favorable, since the organisational structure is better suited for investors.

The main difference between both types lies in terms of public debts and share transfer. Share transfer is more difficult in limited liability companies than joint stock companies, as the share transfer agreement must take place before a public notary. With regards to public debt such as tax and social security debts, in cases where such debts cannot be collected from the legal entity, the corporate veil will be lifted and liability of shareholders will occur.

There is no best structure for only startups but each founder should consider their unique conditions while making the decision. However, in either option, parties should seek professional legal advice while incorporating the company as

well as drafting the articles of association which should eliminate conflict of interest.

2. WHICH AGREEMENTS ARE CRUCIAL BETWEEN FOUNDERS AND OTHER SHAREHOLDERS/INVESTORS?

Each successful business encounters conflicts at every stage but disputes are detrimental even more at the beginning. Startup businesses enlarge in a way that was not anticipated at the beginning that creates new problematic areas not covered in the contracts. In order to minimise conflicts between the founders and other shareholders/investors, a clear shareholders' agreement should be drafted by a professional lawyer who is experienced in working with startups.

Startup business investors typically have minority shareholders' interest which results in limited voting control and a lack of voice in management. In order to have an influence on key business decisions, it is essential for minority shareholders to negotiate on various topics. For instance, although board participation is appealing to obtain the ability to persuade other board members, it requires additional risks. An alternative would be a board observer which allows the investor to have input without any drawbacks of being a board member. Moreover, to avoid self-dealing, high valued transactions made by the majority that can create a conflict of interest between them and investors shall be eliminated by a proper approval system that prioritises minority shareholders. Furthermore, minority investors should consider their exit strategy at the very beginning and negotiate some exit rights such as put options, tag-along or drag-along rights.

3. WHY STARTUPS SHOULD CONSIDER PROTECTING INTELLECTUAL PROPERTY RIGHTS?

New technology and innovation subject to IP rights (such as trade marks, copyrights, patents or trade secrets) are the significant assets of a startup. The products and services that startup presents are keys to make revenue and earn market share. However, neither of them will be secured if the startup does not take any action to prevent rivals from illegally using the inventions of startups. In other words, it is important to register IP rights within the timelines highlighted under the Code of Industrial Property No. 6769, so that others cannot register first or argue ownership against the startup.

Even though an IP right is registered properly, it is not enough to prevent other companies from infringing it. In such instances, working collaboratively with legal advisers to assess if a simple demand letter to the infringing party would be enough or a lawsuit is necessary to enforce rights. In any case, acting swiftly is imperative in order to stop the infringement or avoid any damage that can occur in the future.

Investors would like to see that any IP rights associated with the startup business are protected, since a startup is unlikely to survive unless the IP right is securely controlled. Moreover, IP rights should be assigned to the company, not to the founder himself, as the investment plan is being made in accordance with how much value the IP right adds to the company.

4. HOW TO ARTICULATE EMPLOYMENT CONTRACTS?

At the point where the founder starts to expand his venture, there is a strong possibility that working alone will be difficult due to the volume of the operations. This leads the founder to hire employees who will play a role in the development of the enterprise. As a beginning, startups should always be sure to enter into written employment contracts. Since employment litigation in Turkey is disruptive and expensive, startups should articulate appropriate employment contracts which provide a basic set of terms along with other privileges and benefits.

First of all, for many startups, the key point regarding employees is mostly about the issues associated with the creation of intellectual property by employees. The reason startups are paying for employees is that they expect them to come up with new ideas, inventions and work products. For that reason, employees have access to confidential information belong to the company which are valuable, especially for startup businesses. Therefore, one way to divert any pitfalls is to sign an agreement that not only deals with confidentiality provisions but also provides an invention assignment that states, ideas and work products related to company business created by the employee will belong to the company.

Seeing that all employees of the company have signed the aforementioned agreements is an expectation of investors in startups. Additionally, in a possible M&A transaction where the company is sold, due diligence teams of the buyer will also be looking for these agreements to be signed by the employees. Failure to have these basic issues may tip the scales against the company's favour from the investors' point of view, as it will give an impression of disorganisation.

5. WHICH SPECIFIC LAWS TO COMPLY WITH?

Specific laws regulating industries such as e-commerce, banking and finance, media,



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telecommunication, and biotechnology, etc. should be carefully reviewed. Being aware and complying with specific laws governing their business area, including licences, approvals or certificates are crucial in order to continue the operations of the startup. One of the major areas that affects almost every startup in Turkey is the Personal Data Protection Law No. 6698 (PDPL).

The majority of startups are collecting and processing personal data as part of their services which makes them legally bound with the PDPL. Failure to comply with the provisions could not only result in hefty penalties but also attract the attention of the investors. Investors would like to know if a startup breaches the PDPL in any means, and, most importantly, if PDPL affects customer behaviour which can be vital in terms of the viability of the business model. For instance, customers have a superior voice when it comes to processing and transfer of personal data with right to data portability or right to be forgotten, since a difficulty will occur in terms of free monetisation of such data. Therefore, adopting a viable business development strategy that can only be ensured through a solid background could be a point while attracting further investment.

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CONSULTANCY

For more information, please contact:

Osman Ertürk Özel,
ÖZEL Attorney Consultancy

Kazım Özalp Mahallesi, Reşit Galip
Caddesi, No: 128/8,
GOP, Çankaya / ANKARA

Bağdat Cad. No:417/7 34470
Kadıköy/İSTANBUL

E: info@ozel.law
ozel.law