LS Africa Presents: Venture Voices

Episode 4:
Legal Challenges Part 2 - Capital Structure Issues for African Startups

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JUNE 2024

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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 Tolu Adetayo and I will discuss some of the legal challenges we see in the startup space in Africa. We will provide examples of common legal issues and potential solutions.

It is 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 in future episodes. Instead, we will 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. This will be Part 2 of a three-episode series discussing legal challenges for startups in Africa. Today we'll talk about pitfalls in the way that startups allocate company ownership or capital structure issues. With that said, let's jump in.

Let's switch gears a bit and discuss some of the legal challenges that founders face when they're negotiating terms with potential investors. And I think something that we often deal with, and I think we discussed a little earlier about making sure to have good counsel. And oftentimes we find ourselves with clients that come to us because they may have had an experience with a not-so-great legal counsel, and we are helping them to clean up some of the messes of the past. And one thing that they come to us with is, if they find themselves having given away too much equity too early, and what that means. What kind of issues can that create for founders or future investors that are considering investing in these companies?

Rossie Turman: You got to understand what goes on historically. This is not ECVC point. This is investing in Africa in general, which is you have a lot of family-owned companies, and people invest in a variety of things. And what they're used to doing, if they put in a good amount of money, that they're used to getting anywhere from 40 to 51% or more, because they're putting in the money. If they're starting it, they expect that majority on it, they're just putting money in, they expect a lot. And juice about 40%. That doesn't work in high growth companies, it works in lifestyle companies. It works in slower growth. And so you have a number of families who could invest, could be angels, who don't understand that the model is different in the ECVC space. So they're looking to put money how they have for decades, and it doesn't match up well.

So there's a lot of friction. And so some people aren't necessarily predatory investors. They're just investing the way they always have, or if they go to their father or grandfather, whoever is controlling the family money, they're like, "No! That type of investment you should get 40%. I always got 40%." In a high growth VC, that doesn't work. Why doesn't it work? This is a skin and game argument. You always have to be looking at how much you're giving up between now and when you create the exit opportunity.

If you give up 40% upfront and you need to do four or five more rounds before you get the exit opportunity, by the time you get to these lesser rounds, I mean these later rounds, not lesser, later rounds, there's not going to be enough equity in you to make other future investors, which are where your large checks are coming in, believe you have enough skin in the game, so they're just going to avoid you. So if you give up too much early, you won't have an exit opportunity. You won't even be able to do the later rounds.

Deangeor Chin: Right. And that might be difficult for startups who, a lot of times, it is like smaller checks coming in at the beginning, and a lot of these owners have to be scrappy in investing at the beginning to get a quick safe note or this and that. And having those conversations about, well, first of all, thinking about ultimately the long-term strategy exiting, and how much of the company they're giving away, versus being able to convince someone to cut them a check just to get this dream going. It's a lot to juggle and figure out.

Raquel Smith: Yeah, that's a big challenge. I think any founder of any company is, when you are just starting out and you're bootstrapping, and you're really just getting this idea off the ground, and eventually there come times where someone offers you some money, and that can be really beneficial and really helpful to you at that time, and it's really hard to turn down, but sometimes it might not be the right fit. Because if this check comes along and that gets you through the next few months or whatever the case may be, but the investor wants a ton of control rights, a ton of equity for it, and just so much that comes along with it, it might feel like a good decision in the moment, but ultimately runs you... It creates a lot of issues for you when you're trying to get those way larger checks down the line.

Rossie Turman: One of the things that people may consider, I haven't seen it a lot, but we might suggest it more and more, is for people to use no load vehicles. In other words, this could also help with the flip later. Take your early checks all into a friends and family vehicle or something like that, give the vehicle the rights, and then as people come in, they can fight over the rights in the vehicle, but the vehicle has the rights, and that means you're not giving a particular right to six or seven different people. They all have to work it out amongst themselves through the vehicle. And then you have one master as opposed to seven, and then also all you have to do is slip the vehicle up, and then there's other benefits as well. But if you could direct people into that particular structure, and then you issue the safe slope to the vehicle, as opposed to the individuals they invest in as LPs, so to speak, in this low load vehicle.

Deangeor Chin: Yeah, absolutely. Do we know of any ways that startups can protect their interests during these negotiations with much larger experienced investors that have a lot of leverage in the conversations and the negotiation? I mean, I think one thing that we've been saying quite a bit throughout this conversation is having legal counsel-

Rossie Turman: Good.

Deangeor Chin: To the extent that having good-

Rossie Turman: Good, good.

Deangeor Chin: Good legal counsel in order to help you to navigate a lot of the challenges. Oftentimes your good legal counsel will have seen a lot of the things that you're facing, and it won't be the very first time for them. For you it might be, and that might feel very daunting and scary, but for us, we have a ton of historical knowledge that we are able to pull from to help be creative and get around some of the hurdles.

Raquel Smith: To that, I would also say as the company, as the founder, you have leverage too. There are ways to find compromises. It's not always all or nothing. You don't have to jump every request. There are ways to compromise to understand exactly an investor, what the ask truly is trying to get at. Maybe the request for 50% of the company isn't that they want 50% of the company, but they want to ensure that they have a say in certain decisions and getting kind of to the heart of the true issue or the request, you may be able to find some sort of compromise that will allow the company to grow without crippling it at the beginning with an excessive equity payment.

Tolulope Adetayo: Another thing to note, which we've been seeing a lot, but this is actually very more important for at least to the founders that are going for the first time to raise capital, is liquidation preference. Think about liquidation preference as a safety net for investors. It typically allows investors to have the right to get their investment back before you as a founder or any employees see a dime in the event of any company liquidation. So it's very, very important that you consider this part of it. It's like calling dibs on your slice on the cake before anyone else at the party. So just make sure that you are very important. Just like Raquel really said earlier, that you also have leverage. And all these things are points of negotiation, but we can't really go deeper into liquidation preference right now, but it's one of those things that it should consider pretty early on when you get your term sheet.

Rossie Turman: Yeah, that'll be a great pod for us to do later Tolulope. I think the other thing, it's a psychology on all these terms. Two things, good counsel, you can just pick up the phone and call, and they can tell you whether or not what you're being asked for is in market or not. They can also explain to you what you're being asked. They can also explain to you different options, or what questions you should ask. So they don't have to always be pulled into the negotiation, which is more expensive. Sometimes you should. But they can be your sounding board. That's a good way to use good counsel. It's just that pick up the phone in case of emergency dial, good counsel. Right? The other piece I would say though, is you have to understand where you are in your life cycle, and this kind of dovetails on one of the challenges coming, doing deals in your local area, and then when you start to expand, and now raising money beyond your local area, you're going from the position of scarcity.

In other words, very, very scarce capital, probably in your neighbor friends and family, or who you know, and stuff like that, to now you're a little bit more of a known entity, and you're raising with a group of people who really do have capital. And that's a mindset change about what you should be expecting, what you should be asking for, and they're looking at you to be more sophisticated. That tells them that you're somebody they want to invest in. It's almost contrary. You can't be completely out of the box unrealistic, but if you're too easy, and you're not actually catching on to normal or market points, and you're giving up too easy, I'm not going to invest in you, because I don't think you're going to run your company. Because you're not a sophisticated businessperson. So you got to think about that as well, about your leverage. This is your trial. People are testing. They don't expect me to say yes.

Deangeor Chin: That's great. I think there's a lot that founders can take from their initial conversations with investors and those negotiations, but have we seen any kind of key differences in how African startups would approach negotiations, versus non-African startups? Are there any mistakes that we see that they're making when they come to the table that's, I guess, unique to their positioning?

Rossie Turman: I'm not seeing that. I'm seeing a differentiation globally between if there's a haves and have-nots. I'd say the break really happens between founders who have done this before and founders who haven't. And then the next break would be founders who have access to someone who done it before, i.e. A coach on their shoulder, and those who haven't. And that gap can be shrunk by reading. Riff reading is fundamental. There's so much information out there that you can access online or on Audible, or get a book, or whatever, and you can read, and at least know the baseline of information. And I think that a lot of new founders are so focused on their product and doing it, which is great, but they don't take time to read on how the ins and outs of running the business. And that's the difference between a real business I'm going to invest in, and you just presenting to me a science project. I need to see that you actually can build the business, not just do the NVP.

Deangeor Chin: Yeah, and I think to your point, I don't know if there are any kind of unique challenges for founders with African startups. And to your point, I think doing your... And this is not unique to African startups, I think this is really just early founders entirely, which is being able to do your homework. Because I think especially when you're starting out, we talk about counsel, we talk about good counsel, it's very difficult in the very early stages to I think afford legal counsel. So I think one thing that can be somewhat of your superpower is spending a lot of time trying to understand the terms, trying to understand what is being asked of you, what points investors are trying to make, and what you're giving up by agreeing to certain things. Doing, you know, the internet is a good place to delve really deeply on a lot of things, especially if you're not able to hire outside counsel. To be able to kind of go as far as you possibly can in understanding the terms that you're agreeing to at the outset, before it's too late, and you've already signed on the dotted line.

Rossie Turman: There is one unique issue that we should just highlight. And it's TAM. Total addressable market. And so if you're coming out as a founder at any place other than Nigeria, sorry, but any place other than Nigeria, you're going to run into some TAM question, which is for those of you understand total adjustable market, people are trying to figure out how big can you actually get? And so the difference for the US founder, or say the European founder, is because you have an economic zone that's fairly well integrated in the US, people can look at that overall ecosystem, and look at that as an initial total addressable market. And then they're looking at, and how do you expand beyond that?

If you're in any jurisdiction other than Nigeria, that question is going to come a lot sooner for you. How do you get across borders with whatever it is you're doing? And we're still a way away from a borderless Africa. These conversations going on, that's another conversation for a podcast, but we're still a ways away from that. So one of the things that you're going to run into fairly early, depending on where your operating company is, is how do you get borders into your region. Whether it east, south or Southern Africa, West Africa. That's an issue that you have to be a little bit more focused on for your investors.

Deangeor Chin: And what about negotiating with co-founders or potential co-founders or former co-founders? Are there any challenges that we see from a legal perspective? Or any ways that founders can remain forward-thinking to try to protect the interest of the company? I guess just to give a little more context there, so, in the beginning, it's really difficult to decipher between the founders and the company, right? They're starting out, it's the people, really, when there's really not much of a business to invest in. You're investing really in people, the founders that are coming in with this big idea. But there's a lot, I think, on the legal front at the outset that needs to be taken care of to ensure that over time, that this is handled, and as a company, versus just two people or three people or one, a founder. So is there anything that companies tend to do, or founders tend to do to be able to protect the interests of the company when they're kind of negotiating or dealing with each other?

I think the key thing that always comes up is vesting, right? Making sure that founders keep some skin in the game, and able to make sure that they'll be here for a longer period of time. What you don't want is to have co-founders that you kind of give all this equity to at the outset, they do some or nothing, and then they choose to no longer participate or help out or actually contribute to the growth of the business. And they can walk away scot-free with this equity that they'll hold onto while you are left to kind of pick up the pieces and continue to try to salvage a business.

And if there's ever an exit, they get to just capitalize and enjoy the proceeds of that, but never actually having had put that work in. So I think vesting is a key part of the process in order to make sure that founders are kind of sticking to their interests in growing the business.

Raquel Smith: And I guess we can say for vest- just for listeners who may not know, vesting is essentially setting up a timeline for when equity will be received in the future. So that means that if you are going to receive or if the intent is for you to receive a hundred shares, let's say you wouldn't get a hundred shares today, you would get 20 shares this year, and 20 shares the next year, just to ensure that you remain committed throughout that timeline.

Rossie Turman: Yeah, you guys just said something else, also a little bit more about what you're saying on founder agreements, but before we dive in that, let's just lay it out for folks. The easiest way I have to think about is relationships, right?

So there's a lot of discrepancy or discussion about relationships, as to whether or not you should marry someone, or whether it's okay to live together. If you're talking about a company, you're not going to raise money if you're just living together. You actually have to be married. So ultimately at some point in time, this is going to need to be some agreement. You can have different approaches to when you start to paper that agreement, but you need to know at some point in time you need an agreement.

It's not a company until there's an agreement between you, whether the shareholders give, founders give, whatever you want to call it. There needs to be agreement, and that agreement's going to evolve how you're splitting equity, and we talked about vesting, the timing of people receiving equity. You probably want to have a good understanding of what the roles and responsibilities of people are, how much of that is papered and how much that is just understood, is for you, but clarity is best for yourselves. And then clarity is best to be able to tell investors how you all work together. And them seeing documentation outlines that gives them comfort as well. That's my overview.

Raquel Smith: And I think that's exactly it, and I think we'll probably start talking about these record keeping in order to, I think the founder agreements and making sure that that paperwork is in place is very key. Once a company gets to the stage of raising capital, and going through a diligence process with an investor, it all kind of comes up.

Deangeor Chin: 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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