Russell McVeagh

Technology Start-ups

A Practical Guide

January 2018

Introduction

Topping the World Bank Group's annual ease of doing business ranking for both 2017 and 2018 and consistently ranked within the top three of Transparency International's Corruption Perception Index since its inception in 1995, New Zealand is one of the most deregulated, and least corrupt, economies in the world.

Building on this sound and stable economic foundation, New Zealand's global focus and connections, strong technology ecosystem, and innovative and entrepreneurial culture are increasingly making it an attractive destination for many new technology companies to start and run their businesses.

Technology is New Zealand's third biggest export sector and a recipient of a steady flow of both overseas and local investment. The New Zealand Government continues to invest heavily in IT infrastructure, having now secured the country world-class internet speeds. Low cost barriers to entry, coupled with stable, business-friendly government have contributed to the recent significant growth of New Zealand's thriving technology industry.

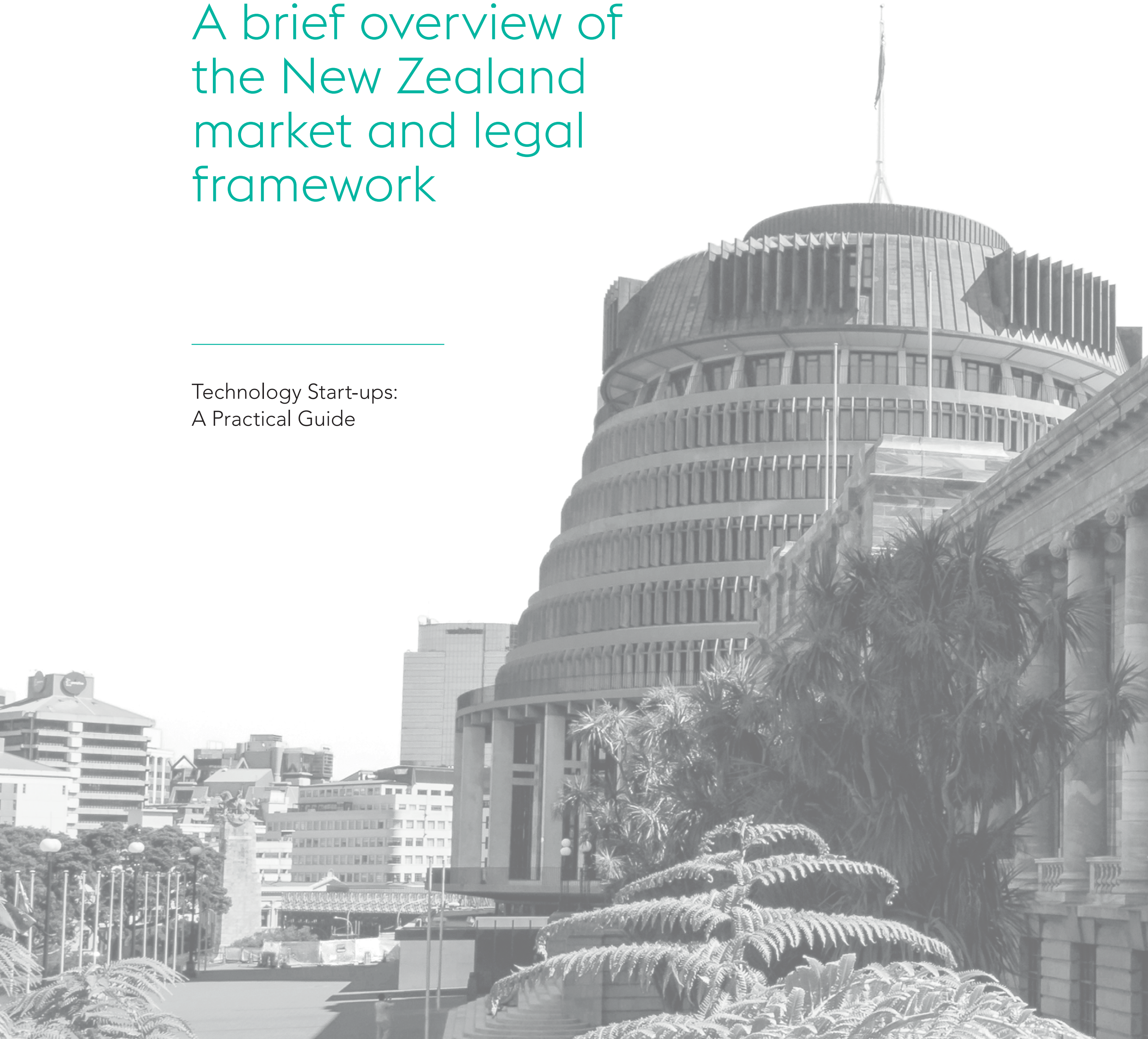
This guide provides some basic advice for start-up enterprises wishing to do business in New Zealand in the technology sector. We set out the key legal considerations that technology start-ups should be aware of in order to effectively protect assets, maximise enterprise value and plan for the future growth of the organisation.

Anyone considering starting up a business in New Zealand, entering into arrangements for the procurement or supply of key technology or intellectual property or entering into funding arrangements should seek advice on the specific details of their proposed venture.

This guide was prepared in December 2017 and may be updated from time to time. It is general in nature and not a substitute for legal, financial or other professional advice.

SECTION ONE

A brief overview of the New Zealand market and legal framework



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A brief overview of the New Zealand market and legal framework

Globally Connected

New Zealand has a rich history of export and strong trade relationships with Asia, the Pacific, the Americas and the European Union. It actively lobbies for free trade and the removal of anti-competitive restrictions. Significantly, in April 2008, New Zealand became the first country to negotiate a free trade agreement with China, and negotiations to "upgrade" that agreement commenced in April 2017. New Zealand has also recently been successful in negotiating free trade agreements and economic partnerships with several other nations and New Zealand's current trade policy includes "continuing with urgency to build on our network of free trade agreements".

For the same reasons that technology companies have been attracted to do business here, New Zealand has also become an attractive destination for overseas investment. It offers sound economic practices with good opportunities for solid growth. Since October 2015, New Zealand has implemented an "Investment Attraction Strategy" to attract more high quality foreign business investment to New Zealand.

Established and Fast Growing Technology Sector

With low barriers to entry and an innovative and entrepreneurial culture, the New Zealand technology sector is undergoing a huge period of growth with over 21,411 technology sector businesses employing 120,350 workers nationwide.

In October 2017, Technology Investment Network reported that New Zealand's top 200 technology companies recorded just over NZ$10 billion in combined revenues (including more than NZ$7.3 billion in export revenues) and supported more than 43,000 full-time staff. As at October 2017, Fintech, Digital Media and Agritech were the fastest growing market sectors.

Notable success stories of 2017 were the acquisition of wireless charging technology company PowerbyProxi by Apple Inc. (for an undisclosed sum) and Rocket Lab raising NZ$105 million of investment from Silicon Valley-based venture capital firm Data Collective, giving Rocket Lab an implied valuation in excess of US$1 billion.

Stable and Open Government and Regulatory Environment

Government in New Zealand is open, accessible and accountable. The regulatory environment is relatively stable. Laws and key Government decisions are generally made after public consultation where any interested person is welcome to make a submission.

The small size of New Zealand and its Government also makes it relatively easy to gain access to and communicate with both regulators and Ministers, their officials and members of Parliament.

New Zealand is almost entirely unprotected by import controls and subsidies. Marginal tax rates are also relatively low, when compared with many other nations. New Zealand offers a low-compliance tax system with various different opportunities for Government funding and support.

In November 2017, New Zealand underwent a change in Government. The incoming Government has announced a commitment to technology, including developing a national digital architecture for the development of fibre optic capabilities, 5G+ in mobile technology, artificial intelligence, robotics, autonomous vehicles, digital fabrication, augmented and virtual reality and the Internet of Things, over the next five to ten years.

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SECTION TWO

Getting Started in Start-ups

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Getting Started in Start-ups

Laying the Right Foundation:

One of the first decisions you will need to make about your business from a legal perspective is what shape your business should take. This will be particularly important if you are looking to raise funds for your business from external investors and lenders in the future.

There are a number of different corporate entities available to entrepreneurs looking to do business in New Zealand, including companies, trusts and partnerships.

Companies

The most common business vehicle used by technology businesses in New Zealand is a company. A company has the benefit of having a separate legal personality. Where a limited liability company is used, this enables the separation of the legal liabilities of your business from your personal assets.

New Zealand companies can be incorporated quickly and inexpensively online.

Key facts about New Zealand companies:

1. **Limited Liability:** Companies incorporated in New Zealand under the Companies Act 1993 ("**Companies Act**") have either limited or unlimited liability. In a limited liability company, the liability of each shareholder is limited to the amount of share capital that they choose to invest in the company. Unlimited liability companies are less common, though are sometimes required for US tax purposes, as unlimited companies may be treated as "disregarded entities", whereas limited companies do not qualify for this treatment.
2. **Shareholders and Directors:** A company registered under the Companies Act must have at least one shareholder and one director. At least one director must be resident in New Zealand or Australia. The shareholders and remaining directors do not need to be based in New Zealand, however, there are additional verification requirements for the incorporation of companies that will have one or more directors that are not resident in New Zealand. Information is also required to be provided as to the residential address and the date and place of birth of a company's directors, including proof of residency and identity.
3. **Constitutions:** A company may, but is not required to, have a constitution. If the company has a constitution, this can provide for variations to the default position provided by a number of provisions under the Companies Act and also empower the company to do certain things which can only be done under a constitution. For example, powers for a company to issue redeemable shares, and to indemnify and purchase director and officer insurance, need to be provided for in the constitution in order to be effective. There are also certain provisions of the Companies Act that a company's constitution cannot modify.
4. **Full Rights:** A company is deemed to have all the rights and powers of a natural person (except where these are specifically restricted in the constitution).

5. **Raising Capital and Listed Companies:** Under the Companies Act, there is no limitation on the number of shareholders a company may have, or on its ability to raise money from the public. All companies are able to apply to be listed and have their shares quoted on a licensed market if the shareholders wish to do so in years to come.
6. **Company Names:** The first step in the process of incorporating a company is to reserve a company name (which can also be done online). Legal issues to consider when choosing a company name are discussed further below.
7. **Ongoing Reporting Obligations:** New Zealand companies have ongoing reporting and record-keeping obligations including, for example, the maintaining of a share register, director interests register and the filing of an annual return. Companies also need to update the New Zealand Companies Office when certain things change. It is important to ensure that these reporting and record-keeping obligations are met, so that potential investors reviewing the business records in years to come have the comfort that the company is in compliance with its company law obligations.
8. **Directors' Duties:** Directors of New Zealand companies have an obligation to comply with the duties set out in the Companies Act. These requirements include that Directors must at all times act in good faith and in the company's best interests (although the constitution may amend this in some circumstances). If you act as both a shareholder and a director, the obligations as a director generally require you to put the company (and not the funds you have invested as a shareholder) first. Directors are also required to exercise their powers for a proper purpose and to ensure that the company does not trade recklessly.
9. **Taxation of Companies:** Companies are treated as separate legal entities for tax purposes (see further below).

Partnerships

General Partnerships: Two or more people or companies may act as a partnership, by carrying on business in common with a view to profit, without incorporating or registering that arrangement with a third party authority. A partnership of this nature is not a separate legal entity and each partner is potentially fully liable for all of the liabilities of the partnership. The Partnership Act 1908 and the common law regulate partnerships. Partnerships of this nature are not required to have a written partnership agreement, but it is always advisable to have one. Due to the potential for unlimited liability, partnerships are not a common structure for new and risky enterprises.

Limited Partnerships: From May 2008, it has been possible to establish a limited partnership in New Zealand. The limited partnership structure is a hybrid between a company and a partnership. It is a separate legal entity, but is fiscally transparent for New Zealand tax purposes. Some key facts about New Zealand limited partnerships:

1. **General Partners:** A limited partnership consists of at least one general partner and one limited partner. General partners manage the limited partnership and are liable for the debts and liabilities of the partnership. Therefore, it is typical for a general partner to itself be a limited liability entity such as a company.

2. **Limited Partners:** Limited partners are passive investors who are restricted from participating in the management of the limited partnership (with the exception of some permitted safe harbours). The liability of limited partners is generally limited to their capital contribution.
3. **Partnership Agreement:** A limited partnership can be formed for any purpose, it has an indefinite lifespan if desired, and there are no limits on partner numbers or investment. It must have a written partnership agreement and be registered with the New Zealand Companies Office.
4. **Other Legal Requirements:** Similar rules around the residency of general partners and information disclosure requirements apply as are described above with respect to companies.

Taxation of Partnerships and Limited Partnerships: Both partnerships and New Zealand registered limited partnerships are fiscally transparent for New Zealand income tax purposes. Each partner is treated as deriving a proportionate share of the partnership's earnings. The partnership is not separately taxed on those earnings, and partnership distributions are disregarded when determining the income of the partners.

This can be advantageous for start-up businesses because it means there is no separate layer of tax at the business entity level (which is particularly important if one of the investors is, for example, a tax-exempt charity). It is also advantageous if the business is expected, initially, to have tax losses. Those tax losses can (subject to certain restrictions) be offset against the partners' other income; and the losses are not at risk of forfeiture (due to a breach of continuity of ownership requirements) if additional investors are brought into the partnership or the partnership is sold.

A brief word on Joint Ventures

Joint ventures arise where two or more organisations lend capital and resources to a common project. Joint ventures can be incorporated or unincorporated. Unincorporated joint ventures are often essentially just operating as unincorporated partnerships and would be regulated as such (as further described above). Incorporated joint ventures operate like companies. Joint ventures should always be entered into by way of a detailed joint venture agreement.

Founder Participation Rights

One of the key commercial decisions involved in establishing your business will be the distribution of the founders' rights in terms of both ownership and governance/oversight. These rights are usually described in the company's shareholders agreement (or, in the case of a partnership, the partnership agreement).

Shareholders agreements are private contracts between the shareholders of the company and remain confidential, whereas a company's constitution is made publicly available on the New Zealand Companies Office website.

The relative contributions and value of each founder should be reflected in the ownership rights allocated to that founder by way of shares and governance rights provided through directorship positions. Each founder's role in the company should be clearly defined. Unfortunately, it is not uncommon for founders to disagree or even fall out, so having a clearly recorded agreement from the start may help avoid this in the first place or provide for what happens should this occur.

Shareholder agreements should also govern:

1. How **significant business decisions** in a start-up should be made (for example, should unanimous shareholder approval be required to enter into a high value contract or make changes to the long-term strategic direction of the company?).
2. How a shareholder's shares should be dealt with if that **shareholder exits** the company. Should they be required to offer those shares to the remaining shareholders first? At what price?
3. **How funding will be obtained** and what the shareholders' rights and obligations will be in these circumstances.
4. How **disputes** will be resolved. This is particularly relevant, for example, in a two-founder start-up company where the ownership rights are equally split – what should happen if the founders reach a deadlock decision?
5. Obligations on shareholders where there is a potential **sale of the entire company**. Can a majority of the shareholders force the minority to sell (known as "drag-along rights")? If the majority decide to sell, should they be required to secure a deal for the minority shareholders as well (known as "tag-along rights")?
6. You may wish to also consider including provisions regarding the **protection of key business intellectual property** and conditions restricting the shareholders from competing with the business and/or soliciting staff.

Business names, brand names and trade marks

There is no business name or trade name registration procedure in New Zealand similar to that existing in many countries. The only means of protecting a business' name or its brand are:

1. the common law right of passing off or a claim under the Fair Trading Act 1986, which provides a measure of name protection by prohibiting misleading or deceptive conduct in trade. Individuals and companies can bring actions under it where it is likely that consumers may be likely to be misled or deceived. This can be invoked in circumstances similar to those which are found in a passing off action;
2. by registering a trade mark or service mark; and/or
3. incorporating a local company or registering a branch of an overseas company with the name in question. Incorporation of a company or registration of a branch gives protection against incorporation of another company under the same name, but it does not prevent another person from trading under that name as a business name, or another company registering a similar name.

We strongly recommend that, where possible, businesses implement all, or as many as possible, of these steps to protect their name and brand. However, before they do so, they should ensure that their name or brand does not infringe any third party's intellectual property rights. This can be done by:

1. seeking legal advice to obtain "freedom to operate" searches;

2. checking publicly available registers, such as trade marks and domain names (in New Zealand and in any markets the business may wish to operate in the future);
3. general internet search engine searches;
4. providing employees with training and detailed instructions on respecting the intellectual property rights of third parties, and the extent to which that material can be used; and
5. making sure that the business and brand names are as distinctive as possible. The less distinctive a brand is, then the greater the risk that trade mark protection will not be available and that other businesses will be able to use the same or similar names.

There is provision under the Trade Marks Act 2002 for registration of trade marks and service marks in New Zealand. This is an excellent way to protect your business name or brand. Trade mark registration only affords protection in respect of the same goods and similar goods to those in which a mark is registered, so it is important to think how the mark will be used – both now and in the future. New Zealand follows the Nice classification system for classes of goods and services.

It is relatively inexpensive to apply for a trade mark. At present, it takes approximately six months to complete registration of an unopposed trade mark and service mark. After filing the mark with the Intellectual Property Office of New Zealand (IPONZ), the application is reviewed and IPONZ will either provide notification of acceptance or a compliance report. If the mark is accepted, then it is advertised for 3 months in the official monthly journal and third parties may oppose its registration. If there is no opposition, then the mark is registered.

IPONZ will not generally permit registration of trade marks and service marks which are considered to be of a purely descriptive nature, as such marks are considered to lack the distinctiveness necessary for registration. The key is to make your brand unique.

If the trade mark or service mark you wish to use is already registered then a licence agreement would need to be entered into between the owner of the mark and the local user. Failure of the registered proprietor and its licensees to use the mark itself over an extended period (currently being three continuous years) in the relevant class of goods, may make the mark vulnerable to being removed from the trade marks register for non-use.

You should also consider registering all relevant and available domain names and social media platforms, pages and handles. Ideally, the sooner, the better.

Funding and Start-up Support

There are a range of alternative ways to get both financial and non-financial support for the growth of your technology business in New Zealand, including:

Traditional Bank Borrowing: In New Zealand there are a number of banks and lending institutions that offer small businesses a range of loans and other types of debt financing.

Government Support: The New Zealand Government and various regional agencies provide a range of different funding and other support programmes, including accelerator programmes, grants and resourcing. In particular, Callaghan Innovation provides grants for R&D focused initiatives and also provides a range of other support to technology businesses in New Zealand.

The New Zealand Government is also proposing to introduce a tax credit for research and development, to encourage greater investment by the private sector.

Incubators and Collaborative Spaces: Injecting funds and other resources into start-ups, there are a number of both general and technology-focused incubator programmes in New Zealand. There are also several platforms and organisations that can assist in finding shared commercial space for technology companies in New Zealand.

Angel, Seed Investors and Venture Capital Investment: A range of angel and seed investors are big supporters of the New Zealand technology industry. This is further described in the "Investment" section below.

Crowd Funding: Peer to peer lending platforms and crowd sourcing organisations are available to assist New Zealand companies to raise funds from the public, including several New Zealand-based organisations. New Zealand was an early adopter of the crowd funding model which allows companies to raise up to NZ$2 million in a twelve month period through a licensed platform (often combined with an offer to wholesale investors known to the platform provider, to increase the capital that can be raised).

SECTION THREE

Operating a technology start-up in New Zealand

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Operating a technology start-up in New Zealand

Keeping your House in Order

If there is one piece of advice we can give to start-ups from a legal perspective, it is to run your business as if you were going to sell it tomorrow. Having acted on both sides of investment and acquisition arrangements of all different shapes and sizes, we cannot overstate the importance of keeping your eyes on the horizon and your house in order, right from day one.

By keeping full and accurate business records and avoiding a couple of common pitfalls, you will make a due diligence process quicker and easier for a potential investor and improve the future value of your business.

In the paragraphs that follow, we offer some insights into what potential investors will look at when deciding whether to invest in your business and what price they are willing to pay.

Use your company name: Make sure you set up your business entity (e.g., a company) early on in the process. Enter into all business contracts, and make all purchases, sales and registrations, in your company's name (and not in your own name or the name of any other founder, shareholder, director or employee). This will ensure that your business owns everything it needs to in order to operate and will avoid difficult and potentially costly untangling of extraneous arrangements in years to come should you ever decide to sell the company. See the "Getting Started in Start-Ups" section above for advice about setting up business vehicles.

Keep copies of everything: Make sure that if your business enters into a transaction, the transaction is formalised and recorded in writing. Even copies of online click-through terms and conditions should be copied and retained. Keep copies of all the contracts that the business enters into, as well as copies of all applications, filings, registrations and any other important or legally binding business activities. In addition, businesses have ongoing obligations of record-keeping and reporting (further described in "Getting Started in Start-Ups" section above). Make sure that you keep those records and filings up to date and stored at the business' registered office.

Check what you are agreeing to: Particularly for key contracts that are fundamental to your business' operations and value (perhaps a critical licence agreement or a high-value customer contract), be sure that those contracts do not give the counterparty a right to cancel the arrangement without due cause. A common clause to watch out for is an ability for the counterparty to terminate the agreement at will, or on notice, without any cause. Similarly, if the contract requires the counterparty to consent to a change of control of your business, this gives them the ability to walk away (or to threaten to do so in lieu of some form of reward) if your ownership structure materially changes. These sorts of issues create uncertainty as to the continuity of key value-drivers in the business and could impact the overall value of your business in an investment or acquisition situation.

Monitor your licence rights: Make sure that you have permission to use all of the products and services that you are using in your business. Keep your license rights current, up to date and ensure that you have permission for everyone in your organisation to use the relevant product or service. It is very common to find that an organisation has forgotten to increase the number of registered licensed users as the organisation has grown, leading both to a breach of licence terms and, often, an expensive true-up liability for the business.

The risks of open source: Consider the use of open source software carefully, particularly if you plan to incorporate that software into your product or service offering. Whilst open source software can generally be used free of licence fees, and be freely modified, the associated licence terms commonly require the user to make the source code of derivative software products freely available if the derivative software products are ever commercialised. Open source software is also usually provided "as is" with little in the way of assurances that the software does not infringe third party IP rights, which could lead to third party claims against your business in circumstances where you may not have recourse against the open source licensor.

Source code for proprietary intellectual property: When it comes to software or other technology that your business has built itself, it is important that you maintain records of the build process, everyone who contributed to it and full and accurate copies of the associated work product and source code. This holds potentially enormous value for future investors, including, in the case of software, the comfort that potential claims of copyright infringement could successfully be defended.

A cautionary word about volunteers: It is common for start-ups to make use of volunteer arrangements whereby individuals will offer their services to the business for free. However, businesses need to be careful to ensure that these volunteers are not provided any form of remuneration or compensation as this could cause them to become employees of your business with employment rights under New Zealand employment law. Another key consideration is the ownership of intellectual property that is created by workers in the course of providing services to the business. This is discussed further below.

Protection of your intellectual property

In addition to registering any of your business names or brands as trade marks, it is important you protect your intellectual property to the fullest extent possible.

Designs and patents: In New Zealand, as in most countries, it is possible to register designs and patents. Some key points to note are:

1. Designs protect the visual design of your product and relate to the new or original shape, configuration or pattern applied to the product by any industrial process. Designs can last up to 15 years and are relatively inexpensive to obtain. However, they are not that common in New Zealand given the copyright protection, which typically exists in "designs", which we discuss below.
2. Patents protect the exclusive right for a new invention. While they can last up to 20 years, your exclusive rights only exist in each country where your patent is granted. If you are considering using or selling a product or service that you want patented in a different jurisdiction from that where the patent has been developed, then you need to give some thought as to the appropriateness of jurisdiction. As a general point, patents are expensive to obtain, and the more jurisdictions you need protection in will inevitably increase costs. As a result, there are a number of strategic points that should be considered before considering applying for a patent.

There are a number of areas in which software is patentable in New Zealand, but the New Zealand Patents Act 2013 has made it difficult to obtain protection for some types of computer programs. An invention is not expressly excluded from patentability under the Patents Act purely by virtue of the fact that it is implemented as a computer program, but if the computer program runs on a general purpose computer (rather than a more specialised device) it may be difficult to obtain a patent for that computer program in New Zealand.

The Patents Act provides the following as an example of a patentable invention that involves computer software: "An improved method of washing clothes when using an existing washing machine, the method being implemented through a computer program on a computer chip that is inserted into the washing machine." However, the Patents Act goes on to confirm that software which simply completes legal documents in an automated fashion, would not be patentable because it merely completes known steps on a computer.

The position is not clear cut and it can be difficult to determine whether an invention falls within the exclusion to computer programs under the Patents Act, but broadly speaking, an invention must do more than simply implement an existing idea as a computer program in order to be patentable under New Zealand law.

Copyright: Copyright law does not protect ideas, rather it prevents others from copying the particular way in which an idea is expressed. Unlike other forms of intellectual property, it is not necessary to register copyright in New Zealand. The position in New Zealand is different to other countries, where copyright needs to be registered in order to be protected. In New Zealand, copyright protection is afforded to original works when they are created, published or performed in accordance with the Copyright Act 1994. The types of works in which copyright subsists include literary, musical, dramatic or artistic works; sound recordings and films; broadcasts and cable programmes; and any digital or hardcopy publications. This includes manuals, brochures, warranties, designs, packaging, logos and advertising. Copyright in software is protected by treating the source code as a "literary work". Copyright protection lasts for 50 years from the end of the year in which the work was made available to the public or was broadcast. In the context of literary works, copyright lasts fifty years from the end of the year in which the author dies.

The person who created the work is usually the copyright owner unless the work is created in the course of someone's employment or someone commissions and agrees to pay for it (therefore reassigning rights, as further discussed below).

From a practical perspective, there are various methods to protect your copyright and proprietary interests. These include:

1. using a copyright indicator (©) on your work, followed by the name of the copyright owner and the year the copyright work was first created;
2. keeping records of information about the creation and ownership of the work;
3. ensuring you own (or at least have a right to use) any intellectual property you pay for; and
4. ensuring you own all copyright in works created by your employees as part of their employment (as further described below).

A key risk for any New Zealand business (including start-ups) is protecting proprietary interests when engaging individuals who are likely to be developing new software, products and technology in the course of their employment or as a third party contractor:

1. Employees: Provisions in employment agreements should make it clear that all

intellectual property created in the course of employment belongs to the business. Often the employee will require that anything created by the employee prior to the employment commencing can be included as an exception in the employment agreement and this is an acceptable approach.

2. Third-party Contractors: Where an independent contractor is engaged to create intellectual property for a business, the default position under New Zealand law is that the contractor will generally own the IP that he or she creates. It is therefore important that the contract between the business and the contractor automatically assigns all IP created by the contractor in the course of performing services under that contract to the business.

Key Commercial and Technology Law

All New Zealand businesses' trading practices are subject to the New Zealand commercial regulatory environment. We set out below a summary of the key pieces of legislation that may be relevant to the day-to-day operations of your technology start-up enterprise.

The **Fair Trading Act 1986** is consumer protection legislation and contains broad provisions prohibiting conduct and representations which are likely to mislead or deceive consumers. The Fair Trading Act is enforced by New Zealand's Commerce Commission and it is not possible for a business to contract out of its obligations under this Act, other than certain sections where both of the parties are "in trade" (and the contracting out must be fair and reasonable). The Fair Trading Act also prohibits unfair contract terms in standard form consumer contracts.

The **Consumer Guarantees Act 1993** is also consumer protection legislation and it contains a number of obligations on both suppliers and manufacturers in relation to goods or services which are ordinarily purchased for personal or household use. The Consumer Guarantees Act sets out a number of statutory "guarantees" that the goods or services must comply with including as to title, acceptable quality, price and fitness for purpose. It is not possible for businesses to contract out of this Act unless the goods or services have been purchased.

The **Privacy Act 1993** protects individuals where personal information about them is collected by a business. The Privacy Act sets out various obligations on businesses, including regarding how personal information may be collected, used and processed and how (and for how long) personal information may be stored. The Privacy Act also provides individuals with the right to access, and correct, personal information that a business may hold about them. All businesses in New Zealand collecting personal information about identifiable individuals need to have processes in place to comply with this Act.

The **Contract and Commercial Law Act 2017** consolidates 11 different contract and commercial law statutes, including rules which facilitate the use of email and other electronic technology in business. Broadly speaking, businesses may use electronic means to comply with various of their legal requirements for producing, giving or storing information in writing (including entering into contracts electronically), subject to various conditions specified in the Act being met.

The **Unsolicited Electronic Messages Act 2007** prohibits the sending of unsolicited commercial electronic messages with a New Zealand link unless the recipient has consented to the receipt of those messages. Commercial electronic messages must also include accurate sender information and a functioning unsubscribe facility.

The **Harmful Digital Communications Act 2015** regulates the sending of harmful digital communications (broadly being communications designed to cause serious emotional distress). Breaching these rules can constitute a criminal offence punishable by up to two years in prison or a maximum fine of up to NZ$50,000 for individuals and NZ$200,000 for companies.

Tax

Taxation of companies: As at the date of writing, the income tax rate for companies is 28%. Companies are taxed on their net income as a separate entity from their shareholders. Distributions by the company to its shareholders are in turn generally assessable in the hands of the shareholder, and may be subject to withholding tax. To avoid double taxation, New Zealand operates an imputation credit system, which permits a company to earn credits (called imputation credits) by paying tax at the company level, and to attach those credits to dividends it pays to shareholders. New Zealand tax resident shareholders may offset these imputation credits against tax they would otherwise pay on dividends.

Employees and contractors: If your business has employees, it will be required to withhold pay-as-you-earn (**PAYE**) tax, together with certain other amounts including KiwiSaver employee contributions and ACC levies, from amounts paid to employees. It may also be required to pay fringe benefit tax (**FBT**) in respect of non-cash benefits provided to employees.

Withholding of PAYE may also be required from payments to some independent contractors (including non-residents, directors and certain other categories of contractors).

Paying yourself from your business: Care should be taken if you pay yourself from your business to meet your personal living costs. How you do this will depend on the structure of your business, but it is critical that your relationship with the business entity (for example, as shareholder, employee or director) is clearly documented and that records are kept.

GST: Your business will be required to register for and charge GST if it makes (or is expected to make) supplies with a total value exceeding NZ$60,000 in a 12-month period.

Other Legal Considerations

In addition to the above, there are also statutory and regulatory controls imposed in respect of specific industry types. Examples can be found in the primary products field, energy resources, fisheries, forestry, insurance, banking, air services and the development of natural resources. Other industry groups are also governed by legislation, e.g. motor vehicle dealers, real estate agents and private investigators.

If your business is developing a product or service that you may wish to export to foreign markets, you should also consider the legal requirements in the export destinations to ensure that your product or service complies with local law.

In the case of new and emerging technologies, it may not be clear how the existing regulatory framework applies to your product or service. Some New Zealand regulators have technology experts in-house and are often willing and able to consult with New Zealand businesses on new technology ventures at reasonably short notice. If you are unsure as to how the New Zealand regulatory framework will apply to your offering, we would recommend seeking legal advice, and, if applicable, engaging relevant regulators early on in the development process.

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SECTION FOUR

Investment

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Investment

Raising capital

Raising capital is often the first key challenge for any start-up entity, once the business plan has been developed. Most start-ups begin by "boot-strapping" (referring to pulling oneself up by one's bootstraps), including using personal finances, the enterprise's revenue and funds from friends and family to provide the capital needed to establish the business. Careful thought needs to be given to taking the risky step of providing security against personal assets, ranging from investments in other companies to the family home, as these could be in jeopardy if the business fails.

As the start-up develops, it is not uncommon for equity to also be offered to financial investors, people who contribute time and resources to the company (say through marketing expertise) and key employees. When this occurs, it is important to have both a shareholders agreement and also comply with the requirements of the Financial Markets Conduct Act 2013 in relation to raising capital. The Financial Markets Conduct Act provides a number of exemptions from the onerous requirement to prepare a product disclosure statement before offering shares or other securities. An important exemption for early stage companies is the small offer exemption which allows a company to offer up to NZ$2 million of securities (e.g. shares) in aggregate to up to 20 investors in a twelve month period, where those investors are all personally known to the offeror. There are some minor formalities to comply with, so legal advice should be obtained, but this is generally a fairly straightforward way of raising capital.

Formal and significant funding is often first obtained once the start-up is meaningfully established through either a venture capital or crowd-funding round. In order for this to be achievable, it will likely be necessary for the company to demonstrate that it is advancing well in its development milestones, has established rights to its intellectual property, and has been able to commercialise its offering through revenue generation. We discuss venture capital financing further below.

Alternatively, a start-up may be able to approach a strategic investor, such as a large corporate on the premise that the start-up is able to develop and commercialise a product that the large corporate would find complementary to its business. Careful due diligence is required on both sides in this scenario. It will be important that the founders are comfortable that they will be able to operate in a more formal corporate environment going forward (if that is the expectation) and also that this does not foreclose options for the company to take alternative strategic directions going forward in relation to the business operation or exit options. For example, a strategic corporate investor may seek first rights on any sale of the business or shares, or be able to veto a subsequent sale to a competitor.

Venture Capital

Participating in an incubator or accelerator, whether in New Zealand or one of the significant start-up hubs such as Palo Alto, will also provide something of a pathway to a venture capital funding round. When engaging with an incubator or accelerator, the incubator may expect to take as much as 5% or 10% of the equity for participating in the programme while offering relatively little money. An important aspect of deciding whether to proceed with the incubator or accelerator is the extent of their industry connection and participation, along with access to venture capital funds for further financings.

Venture capital financing is typically undertaken in the form of what is known as a "Series-A" financing. Essentially, this is a form of preferred share that gives priority in a liquidation or other liquidity event, providing for downside protection. Series-A shares can either be:

1. non-participating, meaning that once the liquidation preference (for example, three times the principal invested) has been repaid, they cease to participate in any further upside; or
2. participating, meaning that they continue to participate pro rata in any upside with ordinary shares once the liquidation preference has been paid.

Series-A shares would typically convert to ordinary shares on an IPO or certain other triggers.

Typically, a venture capital investor will expect an investment that will give it at least a 20% equity stake in the company following the fundraising and a shareholders agreement that provides for board representation, pre-emptive rights on further funding rounds and drag-along and tag-along rights in relation to a sale of shares.

A number of New Zealand start-ups have been successful in raising venture capital funding out of the United States. However, when this occurs, the venture capitalist will often insist that the company "flips" to become a company incorporated in a US jurisdiction such as Delaware, New York or California and that its standard corporate documents are used.

More recently, venture capital funding in the form of other instruments has become common. This includes convertible notes which convert to equity at a discount to the valuation used on the next equity financing and SAFE notes (a simple agreement for future equity), which provide an advance in return for the right to subscribe for equity in a further financing but defer the issue of valuation and, importantly, consequent dilution, until a later date. Care needs to be taken when using these instruments to ensure that there are no unacceptably adverse tax consequences and that the legal formalities are complied with to ensure that they are enforceable and properly understood.

Timing and other matters associated with investment activities

One point we would emphasise, in all scenarios, is to raise capital before you need it. It is easy to underestimate the time involved to approach investors and secure commitments or prepare for a formal crowd-funding round. In the meantime, it is easy to run out of cash, which can stall development and lead to a loss of leverage in negotiating financing terms. In these scenarios, a financing can quite quickly become a "down round" which sees the company raising further money below its valuation, and leads to a significant dilution of the founder's stake.

Once the capital has been raised, the company's share register should promptly be updated and any other formalities completed, such as Companies Office filings and any notices to the Financial Markets Authority that are required (for example, if the money is raised in reliance on the small offers exemption).

It is also important to note that once a company has more than 50 shareholders, it will become a "code company" subject to the provisions of a Takeovers Code. This can have implications for flexibility going forward – particularly when someone wishes to acquire the company on an exit. Helpfully, there is an exemption from the Takeovers Code for small companies seeking to raise further funds through the issue of further shares where this would have an impact on control.

However, this is not currently available in the event of a takeover itself.

Finally, consider how you will communicate with your investors to keep them updated on progress. Generally, the company will be expected to produce annual financial statements and provide them to shareholders unless the company can opt out. Bear in mind that updates on strategy, new customers or other commercial success may be confidential to the company and can fall into the hands of competitors. An appropriate balance of quarterly or half-yearly updates, accompanied with an occasional significant milestone update is often a happy medium to settle on.

SECTION FIVE

About Russell McVeagh

Technology Start-ups:
A Practical Guide

About Russell McVeagh

Widely regarded as New Zealand's premier law firm, Russell McVeagh is committed to operating on the cutting edge of legal practice. With an impressive track record of attracting clients from throughout New Zealand and internationally, the firm acts for numerous technology companies and technology-focused clients across many sectors, including in the energy, telecommunications and financial services sectors.

All of our practice groups are respected as leaders in the market and we assist clients with their most complex, innovative, cutting-edge and challenging transactions. Find out more about our Expertise on our website. We employ approximately 350 staff and partners across our Auckland and Wellington offices, our lawyers are the best in their fields and recognised internationally for their expertise.

Our specialist lawyers broadly operate in the following teams:

1. Competition, Regulatory and Public Law;
2. Corporate Advisory and Technology;
3. Employment;
4. Banking and Finance;
5. Litigation;
6. PPP/Infrastructure;
7. Property and Construction;
8. Environment, Planning and Natural Resources;
9. Tax;
10. Intellectual Property;
11. Sales, Promotions and Marketing Law; and
12. Data Protection and Privacy.

Russell McVeagh

Further Information

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