Delphi News
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”Dressing the bride”

- get your house in order and increase the value of your company

Finding the time for all the administration and paperwork is difficult for many companies. Topping the list of priorities are business development, contacts with customers and suppliers and production. That is the way it has to be, otherwise the business will not work. However, sooner or later, many companies come into contact with an external investor, a partner or a potential buyer who, in addition to valuing the company's business, will also look more closely at the company's agreements, intellectual property rights, permits and corporate formalities etc. A law firm is often engaged to carry out a legal due diligence to identify legal shortcomings in the company. The result of a legal due diligence can, for example, cause a buyer to pull out of a planned transaction or to renegotiate the price. When conducting a legal due diligence on a company for a potential client we are frequently asked about our general feelings in respect of the degree of order that exists in the company. Does the company have its paperwork and its agreements in order? Our answer can, of course, impact on the sales price or in a worst case, it might be a deal breaker.

Order is important in many areas. In this article, I have chosen to focus on two areas – corporate formalities and contracts – and particularly in relation to small to mid-sized owner-managed companies with several shareholders. My reason for choosing to highlight the contractual area is self-evident. Without agreements there will be no business. On the other hand, the area of corporate formalities is perhaps less self-evident. The reason for this choice is, above all, that it is possible to get it right with just a little effort and yet we often identify shortcomings in this area during a legal due diligence.

Corporate formalities

Delphi's request list for a legal due diligence is starting with "Corporate formalities". This is often where we start both when commencing a due diligence and when preparing a final report for our client. "First impression last" is a tired cliché but nevertheless true. Below follows a number of examples of areas in which we often identify shortcomings.

1. **Share certificates:** Some limited liability companies have issued share certificates, others have not. If a shareholder requests it, a share certificate must be issued, otherwise it is not needed. (A company registered in the central securities depository register (SW: VPC), however, has no share certificates.) If the shares are to be pledged and/or deposited, share certificates must be issued for practical reasons. In other cases, one should think carefully before issuing share certificates. It is, in fact, not uncommon that a shareholder cannot find his share certificates when the shares are to be sold, which obviously creates uncertainty for the potential buyer. If a share certificate has disappeared it must be annulled in accordance with the act on annulment of documents. Such an annulment procedure takes more than one year. While awaiting the annulment, it is in a share transfer situation customary that part of the purchase price is held in escrow. If no share certificates have been issued, there

are no share certificates to get lost.

2. **Share register:** A limited liability company must keep a share register in which it must state, amongst other things, who owns which shares. When issuing new shares and when transferring shares, the share register must be updated. Sometimes, several share transfers and/or new issues take place within a short period of time and it can be tempting to think that one will document these at a later stage when all the planned share transfers/new issues have taken place. When a planned share transfer or new issue is postponed or dropped, it is easy to forget to update the share register. It is sometimes difficult to update the share register several years afterwards, since it can be hard to work out which share transfer took place when. In the light of this, it is important to keep the share register constantly updated. Furthermore anyone, at any time, is entitled to get a copy of the share register. The company's auditor will also often ask to see the share register.

3. **Shareholders' agreements:** A shareholders' agreement regulates, besides the articles of association and the Companies Act, the relationship, the rights and obligations of the shareholders in relation to each other. There is no obligation to have a shareholders' agreement but in a company with several shareholders it is often advisable. Not all the issues which can be regulated by a shareholders' agreement can be regulated by the articles of association. In addition, the articles are public information but a shareholders' agreement is not. In a company with a very large circle of owners, it is, however, impractical to have a shareholders' agreement to which all shareholders are to accede. In such cases it is possible that a group of shareholders have an agreement between themselves to which other shareholders do not accede. If there is a shareholders' agreement which is to apply to all shareholders, it is important to ensure that a new shareholder accedes to the existing shareholders' agreement or that a new shareholders' agreement is drafted and signed by all shareholders.

4. **Rules of procedure, instructions for the managing director and reporting instructions:** In a company with more than one member of the board, rules of procedure for the board are to be adopted annually. The rules of procedure regulate, amongst other things, the division of duties between board members. If it is expressed between the board members that a certain director is to specifically monitor and have responsibility for a particular area then it is important, from a responsibility perspective, that this is documented. In the event that the company has a managing director, the board must also specify in written instructions how duties are to be divided between, on one hand, the board and, on the other hand, the managing director. Furthermore, the board must specify in reporting instructions how often and in which way the managing director is to report to the board. It is customary that the rules of procedure for the board, the instructions for the managing director and the reporting instructions are integrated into a single document, which is often called "rules of procedure". Even if no change is made to the rules of procedure, the instructions for the managing director and/or the reporting instructions from one year to another, the board must resolve on the above-mentioned documents each year.

Agreements

It has been said that "an oral agreement is worth the paper it is written on". When a company enters into a co-operation with another company, engages a consultant, buys services or goods or employs someone, the feeling is often positive and both parties are decidedly in agreement. If problems later arise in the business relationship, the parties are suddenly not quite so agreed on when and how the relationship may come to an end, a party's obligations to pay compensation to the counterparty, who owns a certain intellectual property right and so on. The lack of a proper, written agreement often gives rise to difficulties in proving what the parties agreed on from the start. If one does not wish to, or is unable to, prepare a proper agreement which is signed by the parties, one can at least document an oral agreement in an e-mail to a counterparty asking him to confirm that this is what has been agreed. Something is always better than nothing.

Below follows some comments on certain types of agreements which I deem to be particularly important to highlight in this context.

5. **Standard agreements and general terms and conditions:** There are a variety of standard agreements on the market e.g. Orgalime SE 01, NL 09 and AB 04. Standard agreements are often drafted by industry organisations. Some standard agreements are very seller-friendly and others are very buyer-friendly. It is, therefore, very important to consider which organisation is behind the standard agreement and whose interests that organisation represents. In many situations, the standard agreement is a good choice and sometimes it may be the only one acceptable to the counterparty. In other situations, one should avoid a standard agreement and instead draft a unique agreement for the situation the parties find themselves in. All that is needed for a standard agreement, publically available, to form part of a contract between the parties is a reference to the standard agreement at hand. In respect of standard agreements that are not publically available, the opposite applies and it is thus of the utmost importance that such a standard agreement is sent to the counterparty. The same applies to a company's own general terms and conditions. It is not too uncommon for a company to make an offer in which it refers to its general terms and conditions, which the counterparty never gets to see.

6. **Regulation of title to intellectual property rights in employment agreements and consultancy agreements:** In respect of employees and consultants working on the development of a company's intellectual property rights, it is important to state carefully who is to have title to the intellectual property rights that arise as a result of the work/assignment. Both parties often presume that the title shall belong to the company. In the absence of the parties' regulation of this matter, the title will in certain cases belong to the company and in other cases belong to the employee/consultant. There is mandatory law in respect of the right to patentable inventions of which the employer is inventor. The starting point here is that title to patentable inventions belongs to the employee. If the invention has been developed within the framework of the employment, the employer does, however, have the right to acquire the title to the invention in return for reasonable consideration. If no reasonable consideration has been paid, an employee can afterwards successfully claim that the

company does not have the patent to an invention of which the employee is inventor.

7. **Agreements containing confidentiality clauses:** By using non-disclosure agreements, a company can restrict the right of partners, customers, suppliers, consultants etc. to disclose confidential information regarding the company and its business. Non-disclosure agreements can be entered into separately or as a part of another agreement. In all cases, one should consider whether the confidentiality clause should be combined with a fixed penalty, i.e. a predetermined sum of damages. It may also be valuable in a non-disclosure agreement to remind the counterparty that breach of the confidentiality undertaking – in addition to a penalty and/or damages under the agreement – can in certain cases constitute a criminal act under the Trade Secrets Act and this can result in fines.

8. **Agreements containing non-compete clauses:** By using non-compete clauses in agreements with customers, suppliers, employees, consultants etc. a company can limit the risk of these parties starting up business which competes with that of the company. The scope of non-compete clauses is, however, heavily regulated and it is relatively common that non-compete clauses are declared invalid. In order for it to be as likely as possible that a non-compete clause withstands legal scrutiny, it is very important that they are drafted correctly and do not, for example, embrace a too wide geographical area or a too long period of time. A non-compete clause in an employment contract must also include with an obligation on the part of the employer to pay economic compensation. As with confidentiality clauses, non-compete clauses should be combined with a fixed penalty.

9. **Agreements with non-solicitation clauses:** It is well known that non-compete clauses are often declared invalid and therefore they do not always have the intended deterrent effect. One can instead, either as a complement to or instead of a non-compete clause, insert a non-solicitation clause into agreements with customers, suppliers, employees, consultants etc. By using a non-solicitation clause, a company can restrict a counterparty's opportunities to solicit the company's customers and/or employees. A non-solicitation clause must also be reasonable and may not be too far-reaching. In relation to non-compete clauses in employment contracts, a significant advantage of a non-solicitation clause is that it does not need to entail an obligation for the employer to pay economic compensation.

Ahead of the sale of a company or a large external investment in a company, it is relatively common that the seller allows the company to undergo a vendor legal due diligence. Through the vendor legal due diligence, legal shortcomings can be identified and corrected before the company is subject to the customary legal buyer due diligence which is conducted on the instructions of a buyer or external investors. A vendor due diligence is often well-invested money – shortcomings can be identified and remedied. The seller "dresses the bride". Continually "dressing the bride" – during the entire life-cycle of the company – is however often simpler, cheaper and better. But one thing is for sure, it will not make matters worse if the bride gets a little extra beauty care before her big day.

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