

Playing the Same – Intellectual Property & Business Models

What this paper is all about

- Identifying and accommodating market conditions for technology based start up business models;
- The business model requirements of venture capital;
- Practical methods of putting in place the new business model;

in respect of the commercialisation of Intellectual Property .

Anticipating problems before they arise

Raising investment capital in Australia has generally and previously been difficult and time consuming. Australian banks and other funding institutions were not particularly comfortable with investing in, nor lending to, Businesses where the prime focus is the commercialisation of intellectual property. Especially due to the e-commerce investment boom, that attitude may be changing.

There are two kinds of investment capital, namely:

- Debt – which the borrower must repay; and
- Venture/Equity – which gives the investor a share of the Business of the investee and is not automatically repaid by the investee Business, but rather relies on the investor realising the equity held in the Business.

Debt finance is generally “secured” by a charge over the Business’ assets so that in the event that the debt is not repaid as agreed, then the assets are sold by the lender and the proceeds applied to reducing the outstanding balance of the unrepaid debt. As well, the lender generally charges an interest component. Accordingly, debt finance is a risky option for both the lender and the borrower. A fledgling Business based on IP might not have any, or sufficient, cashflow in order to repay Debt finance. Another difficulty is the lending institution's traditional reluctance to take security over intangible assets which are perceived to have an uncertain value and an unsteady market for immediate resale in the event that the lender intends to sell the charged assets.

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Venture Capital, however, generally affords the investor a certain percentage of equities (shares or units) in the vehicle which owns/conducts the Business. As well, in order to protect this equity investment the investor is given at least one representative on the board of directors of the vehicle and other contractual concessions generally by way of a Subscription Agreement. For the venture capitalist, their return depends upon the investee's profit predications actually coming true. Otherwise, there will be no return on the initial investment. Sometimes the venture capitalist also characterizes some of the initial investment as debt finance, taking a charge over the assets of the Business. A combination of shares/units in the Business plus a secured loan gives the venture capitalist a considerable power over the investee Business.

Generally retail banks lend money to Business – requiring the director, to provide personal guarantees and/or collateral security over real estate already owned in order to secure the debt. For this reason, many Businesses involved in commercialising IP prefer to use venture capital which accepts that repayment is linked with the Business success.

To maximise the ability to attract investment capital for an IP-based Business, the entrepreneur will need to have a general understanding of what the venture capitalist demands in return for providing funds to commercialise the IP product.

The Business structure must be carefully planned before venture finance is sought, anticipating the normal due diligence procedures which will be adopted by the venture capitalist in assessing the suitability of the Business to an investment.

The likely range of advisers to help you prepare the Business's structure for venture capital input, will include a patent attorney, a lawyer, an accountant and/or a management consultant. It's unlikely that any one of this group will have the sole or exclusive expertise to entirely restructure the whole Business, so good project management skills are required to effectively combine the respective and complementary expertise.

What the venture capitalist expects

Venture capital is the most commonly used and generally the most appropriate investment mechanism to finance the commercialisation of intellectual property. If the profit predictions about the Business don't eventuate, then the investor doesn't have to repay your investor. However, if the Business does prosper as predicted, then the venture capitalist will get a higher return than the lender's interest rate.

Venture capital is high risk/high return investment which is particularly suited to the dynamic IP-based Business. Venture capital is allocated to early start up companies which are unable and/or unwilling to offer conventional debt based security (such as personal guarantees and collateral security over real estate).

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However, unlike equity or debt loans the experienced venture capitalists will impose certain conditions on their investee Business which may impact on your willingness and/or ability to use venture capital as the mechanism for your Business: For example,

1. Often the investor will nominate a director to your company's board of directors. As such, the investor becomes your 'partner' in the management of your Business. If the Business prospers, so too will the venture capitalist's investment. If the Business fails, the investment is lost – because unless the investment is also partly framed with a debt component, there's no automatic right to repayment of the original investment.
2. The investment capitalist can reasonably request from you in return for the risk involved with financing your Business:
 - that you manage the Business in a predictable way and, if certain specified events occur, there will be specific contractual mechanisms in place to enable the venture capitalist to protect the investment, and
 - that they can expect high returns on their original investment, not less than 20 per cent per year profit on the amount they've invested to justify the risks involved.
3. negotiate a deal with your investor (that is, allocate a percentage of your Business's issued share capital to the investor in return for them providing the actual venture capital), with the allocations generally determined by the anticipated financial return for the investor. Arriving at the actual share allocation is by way of negotiation between the parties. Generally the more assured the investee can convince the venture capitalist his proposed rate of return is – then the less equity the venture capitalist can command. Conversely, the higher the risk the more equity the venture capitalist can expect to receive for the investment. For example, if the investee has an existing or shortly expected and strong cash flow, then the venture capitalist is likely to get fewer shares.
4. identify a plausible exit strategy for the venture capitalist who'll want to know precisely how they'll realise the capital gain on their investment when they leave the Business. Generally, it takes between five and seven years (*NB: This figure is different from the one in section 6*) for the venture capitalist's investment to be realised by a successful exit from the venture. The options for the venture capitalist are:
 - floating the company – either on the local stock exchange or increasingly on the American NASdaq exchange;
 - the original investors buying out the investor; or
 - the Business is sold – often to a competitor.

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What capital venturers look for from owners

The Commonwealth Department of **Industry**, Science and **Industry** (now Industry Science and Resources), undertaken by Ernst & Young and the Centre for Innovation and Enterprise, showed that the most important factors venture capitalists looked for were that:

- they felt comfortable with, and trusted, the person seeking the venture capital
- the risk evaluation and return analysis fell within investor guidelines
- the Business owner and/or CEO's track record was good
- the owner/CEO had relevant experience in the industry for this Business
- the skills and competence level of the management team and CEO were high
- the market growth potential based on size and competitive environment had been identified
- the Business was in an industry which met investor requirements
- there was strong potential for capital growth.

This study also cited inadequate protection of the IP as an important reason for capital providers declining to invest. For this reason, it's important your Business plan includes a strong program for protecting your intellectual property before approaching a potential venture capitalist.

Patience, foresight and planning by all persons involved characterise a successful venture investment.

A robust Business plan is essential in obtaining venture capital. It must show:

- prudent focused strategies for the next five years
- an experienced, enthusiastic management team with specific objectives
- a good marketing plan
- strong market opportunity and methods of realising Business opportunities
- focus on the domestic market with potential for international expansion
- an IP portfolio able to protect those aspects of the Business which determine the venture's success
- viability and revenue projections, pricing and gross-margin strategies
- potential to grow revenue by 20 per cent a year
- a potential pre-tax internal return of between 30 and 50 per cent.

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The Dilution Factor

Studies have shown that before a Business is sufficiently mature to be the subject of an Initial Public Offering, it may need up to seven tranches of venture capital investment. Successive investors will require different conditions for their respective investments.

Each of these successive rounds will unavoidably dilute the equity holdings of the original entrepreneurs who founded the company/trust and who thereby became directors, shareholder or unitholders.

So, if the original Business promoters were allocated certain percentage shareholdings based on their:

- original monetary investment, and/or
- entry into a service agreement, and/or
- the assignment of actual or future IP rights

these original percentages are unlikely to be maintained once successive venture capital investments are in place.

Inevitably and unless these original shareholders/unitholders accept the various opportunities to get out of the company/trust at specified investment points, their relative shareholdings will inevitably decrease each time a new investor or purchaser comes on board.

The only way to effectively protect against diluting this original investment is to ensure the original promoters have a distinct class of shares that can't be diluted a mechanism generally an acceptable to professional venture capitalists.

Accordingly if the original Shareholders can't succeed in negotiating their allocation of these non-diluting shares and notwithstanding the arrival of the venture capitalist, then they must seek some solace in the provisions of the Joint Venture Agreement to oversee their ongoing relationship with their venture capitalist partner. The actual provisions of the Joint Venture Agreement should recognise that, in effect, all participants are, per se, minority shareholders. Share/unitholdings determine income distribution and sale on exit – the 'power' aspects of control and management are separate and regulated by the Joint Venture Agreement.

The other changes ensure each existing participant has guarantees from both:

- the other participants; and
- the actual vehicle/s

about certain management factors about how the Business is to be conducted and which assurances have determined the investors participation in the first place.

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A Business structure for IP-driven Businesses

Given that only five (5%) per cent of technology driven start-ups are still trading after three years, a structure which actually protects your Business's IP assets is viewed positively by investors. Generally venture capitalists know things can go wrong for IP "start-ups".

How the overall legal and trading structure is set up at the outset of the Business is vital to the ultimate survival if not success, of the IP-based start-up Business. This structure is critical whether a venture capital is required or not.

The structure adopted at the outset should recognise the legal and structural factors most likely to lead to a successful pitch for venture capital. These factors must be adopted legally, and be enforceable in times of dispute. The structure must:

- be able to accept an equity investment by the allocation to your investor of negotiable equities – such as shares in a company or as units in a unit trust – which have the capacity to increase in value and be can be sold on demand;
- ensure that the valuable IP to be commercialised– the prime reason for the investment – is exclusively and unambiguously owned by the entity (company or trust), in which all or part of the venture capital investment will be made by the investor.

The company/ies which actually conduct the Business is/are also an actual party/ies to these proposed legal arrangements. Since each individual participant is generally in itself a minority shareholder and/or director, then they can be individually outvoted unless certain contractual assurances are given by the other participants with the actual Business vehicle persons. This agreement balances the interests of all participants (including the venture capitalist) notwithstanding their individual minority status and the risk involved in the overall venture.

By the entrepreneur seeking investment capital without first adopting this structure, the venture capitalist would be obliged:-

- to educate you; and
- then structure your company appropriately

before subscribing for shares. The conditions that the venture capitalist will then impose will favour the venture capitalist. Better the investee prepares for the investment. As lawyers say, "he/she who drafts, wins!"

Protecting your IP through Appropriate Location

The most commonly used entities for conducting an IP-driven Business are either a unit trust or a private company. This is because investors want to acquire negotiable equities in return for their investment by way of subscription (units or shares) which have the potential to

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increase in value and which they can sell when they choose. Generally, the venture capitalist will invest the investment by way of the subscription for shares/units because this ensures the investment goes into the actual Business. Sometimes the venture capitalist might acquire some of the shares/units from one or more existing shareholders/unit holders – ensuring these original participants get a return.

For this reason:

- a discretionary unit trusts;
- partnership; or
- unincorporated Joint Ventures

are not appropriate business if the owners wish to use venture capital. In each of those aforementioned structures, the title to the IP assets is held jointly and severally by all the participants (as opposed to distinctly and individually) therefore investors can't make individual capital gains nor can they trade stock on demand without their co-equity holders' permission.

Deciding on which investment vehicle you'll use to trade in your new Business also raises an important legal and tax issues issue.

Because the majority of Business start-ups fail as a commercial propositions and go into insolvency, an increasing trend has been to separate the trading (and risk activities) from the ownership of the IP rights. This separation is achieved by the original owners setting up two entities:–

- the holding entity holds the IP; and
- the trading entity assumes the risks of trading with the general public.

In this situation:

- The original shareholders and directors transfer to the Holding Company all their IP rights in and to the IP – both as such rights currently exist and as they will exist in the future and in relation to the Business;
- The Holding Company then licenses the use of the IP to the trading entity which actually conducts the trading activities.
- The two entities are connected by a licence in respect of the IP and by common shareholdings.
- The original entrepreneurs who start the Business have the share holdings in both entities and have nominees on either or both boards of directors. Their control is assured.

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This configuration of:

- two distinct entities, and
- separation of IP ownership and IP use

are set out in the diagram referable to the Case Study which follows. The other practical steps dismissed in this chapter will be referable to this Case Study.

CASE STUDY

Toby Buzzcok has developed a new kind of anti virus software for downloading random music on the internet and avoiding bringing a virus onto the recipient machine. Toby writes a Business Plan, a copy of which attracts Sarah Smooze. Sarah is prepared to leave her job as the editor of a prominent music journal and help Toby with the launch and marketing of his product. Sarah names the software "D-Load", however, they need further money to launch the software – so they approach Ventek, a venture capital company. Larry is the managing director of Ventek. After discussions, Ventek agrees to invest \$800,000 in the commercialisation of the software.

Toby has undertaken extensive beta testing with the software but admits the “the internet is the ultimate quality assurance”. He has been frank in the Business Plan in admitting that there are legal uncertainties of the copyright position in downloading music from the internet. Larry sees the need to balance this risk aspect within the corporate structure.

Two companies are established:-

- D Load Holdings Pty Ltd (“Holdings”) – and into which the intellectual property – copyright and trade mark – has been transferred;
- D Load Trading Pty Ltd (“Trading”) into which the Intellectual Property is licensed by Holdings.

Sarah has two daughters with her partner, so Sarah’s Family Trust is established to hold her shares in both companies. Toby is not married and decides, after speaking with this accountant, to hold the share in his name. Ventek identify an academic from a local university who accepts Ventek’s invitation to be their nominee on D Load Holding’s Board of Directors. Larry declines to be a director of the trading company. Even though Toby and Sarah have only just met, they had established a Shareholder Agreement before they issued an invitation to Ventek. The Heads of Agreement for the Shareholders Agreement, proposing Ventek's involvement, is included at the end of this chapter. The two company structure was proposed by Toby's Solicitors, Crawshaw's of Geebung. Sarah proposed and Toby accepted the accountants Quartermass.

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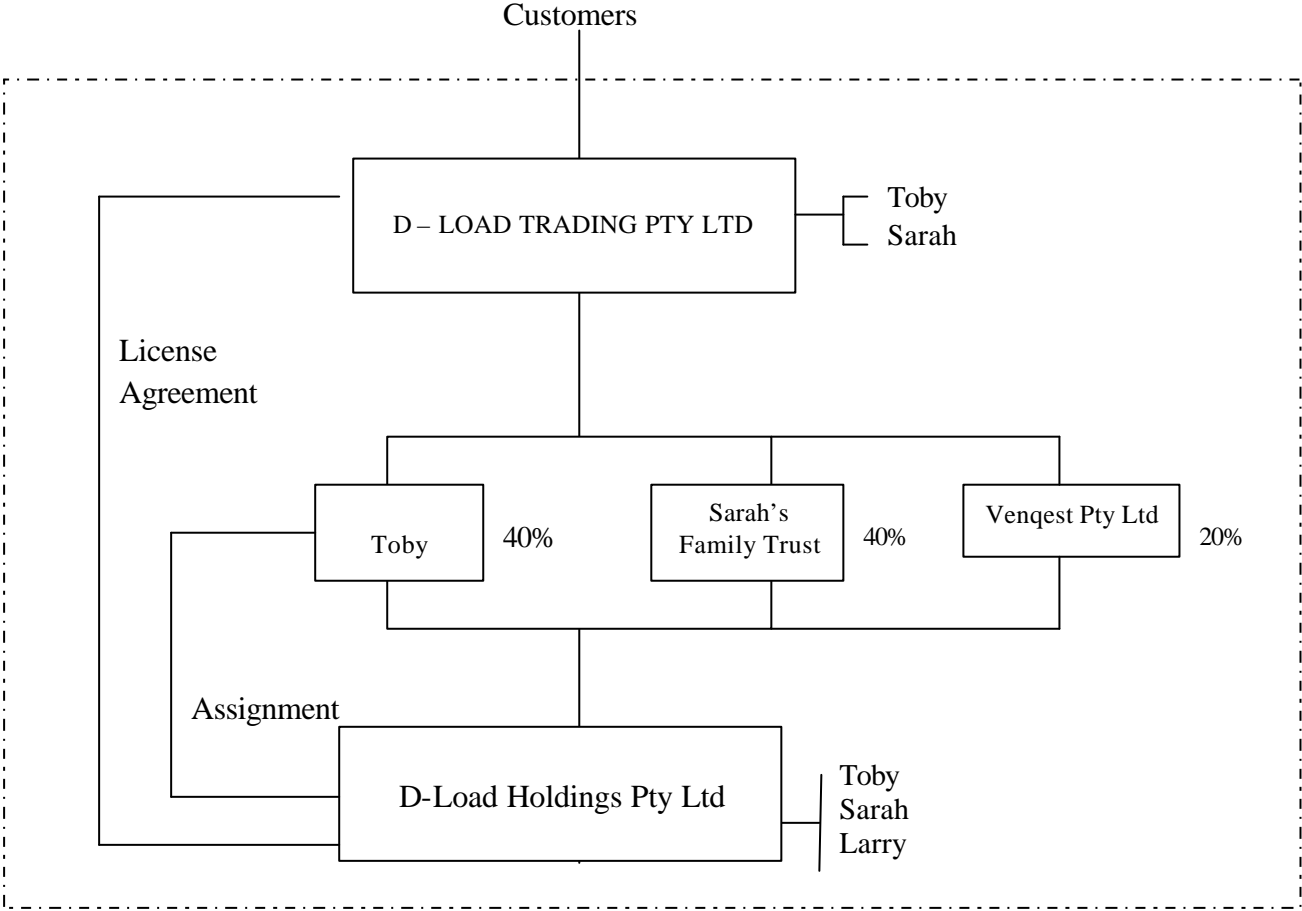
Because Toby's Business Plan promises Ventek that there is no current competition on the internet and licence D Load will have "first user advantage" Toby and Sarah are able to negotiate the following share allocations, namely:-

- Toby – 40%
- Sarah – 40%
- Venqest – 20%.

A diagram of the overall transactions is set out below, and is adopted in the Joint Venture Heads of Agreement included and the end of this chapter. The Agenda for the first meeting between Sarah, Toby and Larry is also annexed along with the Agenda for the final meeting at which the actual documents are signed.

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COMPANY STRUCTURE
D-LOAD



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How does this two company structure protect a Larry's investment and the IP.

- As soon as there are signs that the trading entity may commercially fail and become insolvent, the IP licence from the holding company to the trading company will be automatically terminated in accordance with provisions to that effect in the License Agreement;
- Because the title to the IP rights – the most valuable component of your Business – remain in the holding company and the trading company holds no valuable assets, the trading company's creditors or insolvency administrator would not be able to have access to these IP rights.

To be an effective strategy to protect your IP – and to also minimise tax issues as the value of the IP increases - the timing of the adoption of this two company structure can determine whether or not it's regarded as "commercial" and licence enforceable as against a liquidator, receiver or administrator.

- If this two-company structure is established very early in the entrepreneurial process preferably, before any trading has occurred, then a liquidator in control of the trading entity's remaining assets is unlikely to be able to access the intellectual property.
- However, if this structure is created after there are already creditors in the original trading company, this mechanism stands a sizeable chance of being overturned as 'uncommercial' under the provisions of Corporations Law and the liquidator of the trading company may well be given access to the IP in the separate holding company as well as to the directors who are personally responsible for the assignments.

Toby and Sarah will need preliminary assignment contracts to ensure the appropriate holding company owns the unencumbered rights to the software.

However, unless ownership is officially assigned to the appropriate entity, the IP rights will remain legally with their 'author', who's:

- both a shareholder and director (ie Toby); latter
- the trading company which is employing the research and development team or sub-contracting that process would be the owner.

There is no central database for ownership of copyrights. Location of rights to confidentiality and goodwill can only be confirmed by actual contracts. Contracts assigning IP rights to the appropriate vehicle, which are signed by individual capital shareholders and directors as well as third party contractors, must be sighted by a venture capitalist prior to

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making the investment. Contracts are especially significant in respect of copyright, confidentiality and unregistered trade marks because these three forms of IP rights do not have a public ownership register, which might otherwise clearly define this point.

IP ownership is not automatically cross referenced with the law concerning corporations, partnership or trusts. In other words, shareholding, unit-holding or directorships are not, of themselves, sufficient to automatically assign IP rights to the actual company or trust. Only contracts, actually signed by the authors/owners of IP, can achieve this assignment.

Structuring the investment vehicle – Joint Venture

The legal structure for a Business which is commercialising intellectual property must be able to accommodate the following six (6) factors, namely:

- the "capture" and commercialisation of IP rights;
- personal relationships amongst the participants are based on self interest and financial ambition;
- high degrees of commercial risk;
- the Business is servicing often unpredictable and dynamic markets, where
- neither the promoters nor the venture capitalists make a significant return until they leave the venture, and then only if the original Business plan predictions are realised or exceeded;
- taxation

Standard corporate constitutions cannot accommodate these transactional factors. Accordingly, the original shareholders and directors, who:-

- establish the Business; and
- write the Business Plan,

must specially prepare their company structures to predict solutions to these issues. Essentially, while a series of names are given to these mechanisms (Shareholders Agreement, Unitholders Agreement, Constitutional Agreement), the relationship to be formed can also be described as a "Joint Venture". The project's vehicle (company or unit trust) will have a revised relationship with its members and directors. These contractual amendments will effectively reconstitute the company or trust as an incorporated Joint Venture – a modern

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commercial “term of art” used by Businesses, lawyers and accountants. In America and South Africa, companies operating with only a few shareholders have been called “close corporations” because the shares are “closely held”. There they are regarded as a distinct category of business structure and in many states have their own “close corporation” legislation – fusing principles of company and partnership law. An attempt to pass specific close corporation legislation in Australia, failed in the late 1980’s. Now these relationships be clarified by a private contract between the participants.

Despite the sophistication of standard ‘off the shelf’ corporate contractual and statutory arrangements, they cannot deal with the five inevitabilities listed above . Fundamental amendments must be made to the standard model.

A “Joint Venture” is a term of law used to describe a commercial and legal combination of participants working collaboratively towards a specific commercial goal. The participant include the directors, the shareholders and the respective entities chosen as the vehicle for the venture.

Like intellectual property, the expression “Joint Venture” is another inclusion of the ‘new vocabulary’ to be adopted by which the persons commercialising IP.

Australia has a rich tradition of using the joint venture Business model in the mining and property development industries. Now it is being adopted to IP commercialisation.

Whilst a full Joint Venture Agreement cannot be included in this chapter for purposes of space, a Heads of Agreement which prepares the original Business for the ultimate adoption of such an agreement, is included and drafted in the context of the DLoad Case Study. These Heads show how the diverse elements of the joint venture interact to create this special hybrid company/trust which is called a joint venture.

The provisions of a Joint Venture Agreement are additions and amendments to the standard off-the-shelf constitution of the company or trust. Various provisions in the Joint Venture Agreement cross referenced with the actual provisions in the Memorandum and Articles of Association and/or the Trust Deed. However there is no obligation to put such an Agreement on the public register at the Australian Securities Commission. These arrangements remain confidential to the participants.

Not all Joint Venture Agreement provisions are cross referenced with the constituent documents – just those which impact on certain provisions normally dealt with by the standard constitution (such as the transfer and allotment of shares). A provision should be inserted in the Articles of Association or the company or the Trust Deed making the company or the Trust constitution subject to the provisions of the Joint Venture Agreement. Any

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inconsistency between the Joint Venture Agreement and the Constitution is resolved in favour of the Joint Venture arrangement.

An incorporated joint venture will be recognisable to venture capitalists and their specialist professional advisers. If the founders of the venture don't set all this up, the venture capitalist will do so in their Subscription Agreement.

The project's vehicle (company or unit trust) is commercially and legally distinct and self sufficient from its members and directors. Hence, the respective interests of

- the company/trust on the one hand; and
- its shareholders/unitholders on the other

may not always coincide – especially if a member or director leaves to compete with the former partners. Knowledge workers are highly mobile. The Business requirements, from time to time, may be in conflict with the individual plans of the actual principals. Even if directors or shareholders leave or are ejected which is often necessary for an IP's commercialisation – it's important that the companies continues to function and prosper.

Shareholders or directors can disagree with each other often intractably. To the extent possible, planning and discussions about such anticipated problems will avoid their subsequent occurrence. Otherwise disagreements can only be resolved through lengthy, expensive and complex court cases which a fledging Business can ill afford. The Corporations Law does not provide simple correctional measures for directors' and shareholders' disagreements. By discussing and recording agreements about certain undesirable outcomes, up front, the Business objectives and detailed operations, will reduce the prospect unwanted clashes between participants.

When members of small companies have disagreements amongst themselves, Australian courts impose various standards their operations, essentially treating them as "incorporated partnerships". These "court-imposed" standards may conflict with the personal (and often naïve) expectations key players have about each other and their Business when they "kick off" the Business. Accordingly the obligations assumed by the participants to each other need to be analysed in the context of these statutory remedies.

For example, in our D-Load Case Study, Toby must recognise that any failure to keep arrangements originally reached will have a legal implication (eg he can't decide he doesn't like Larry and simply dismiss him). Sarah and Toby can't change with impunity their mind from what was originally agreed. Such a change of heart could well justify an order from the Supreme Court, under the Corporations Law, that the whole company be wound up, or the one of a number of other remedies provided by the law. The unexpected outcomes must be

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anticipated when the parties are sitting around at the deals outset, “chewing the fat” and making promises. Larry, as an experienced Venture Capitalist, know this and ensures his Subscription Agreement knows this. Broken promises can have unexpectedly grave outcomes in these small companies. Larry's Subscription Agreement:

- understand the significance of "start up promises" of Sarah and Toby; and
- record their understandings clearly by way of a written signed agreement, superseding vague unrecorded promises.

In brief:

- A new enterprise driven by technology and intellectual property can only be established with a lot “of strings attached”. commercialising new ideas is a hard job. Progress is unlikely to be always smooth. The down side must always be heeded in planning. This is called “sensitivity analysis”. Anticipate the unexpected.
- Allocate the risk of commercial failure to a company which does not own any of the IP. That way, if the venture fails the participants won't lose their most valuable asset – their technology.
- Negotiate and implement the Joint Venture Agreements carefully to ensure you build a legal foundation of trust and cooperation. Fiduciary duty applies between the co-joint ventures – preventing each member taking advantage of his/her co-members. The elevated standards of behaviour expected of those with fiduciary duties to others, apply to Joint Venture participants. Use the process of Business planning and setting up legal arrangements as a screening tool to assess which participants are most likely to survive the rigours of commercialising IP. A potential partner who can't rationally discuss problems at the outset, is unlikely to deal with them once they occur in real life.
- Ensure the participants actually go through a process of well-supervised negotiation before settling the actual Joint Venture Agreement. This way they'll learn about their own and other participants' ambitions and interests. Each participant can/should be separately advised as their interests as shareholders may not be the same. Even the respective trust/company can be separately represented. Everybody should know where they stand as the venture is likely to be either very successful or very unsuccessful.
- A well-planned structure will help ensure the venture capitalist is confident that the entrepreneur realistic in what they are setting out to achieve.

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- Consider the taxation implications.

Revenue Issues

The complexity of the Australian taxation system has been further complicated in recent times by the conduct of a substantial tax reform program. Initiated by the recommendations of the Ralph Committee, a number of broad sweeping taxation changes have been introduced with many other reform measures still in the process of legislation drafting.

When it is noted that the highest marginal tax rates for individuals is 48.5% on earned income above \$60,000 and that corporate tax entity tax rate is 34% (30% from 1st July 2001), it can be seen that tax is an important component in any income or asset decision.

Capital gains, subject to the following comments, is taxed like any other income. There is no special capital gains tax rate. Accordingly, special care needs to be exercised when dealing with intellectual property assets or interest therein to ensure that unwanted taxation consequences do not arise.

Without wishing to delve into tax detail, it may be of interest to understand how CGT applies to intellectual property in Australia:

Any disposal of an asset acquired after 19th September 1985 will be subject to the CGT regime. The following concepts are noteworthy;

- An asset is defined to include :
 - (a) any kind of property; or
 - (b) a legal or equitable right that is not property eg., personal rights such as restrictive covenants.
- A disposal including any situation where there is a change in beneficial ownership, or where consideration is received in respect of an asset;
- In the absence of consideration being received, market value is used as the measure for consideration.
- A partial realisation of intellectual property ie., grant of a licence or other equitable interest in the intellectual property is deemed to be a disposal of the asset. Interestingly, the capital gain (if any) is calculated by deducting from the capital proceeds of the granting of a licence, the asset's cost base. In many start up situations the cost base is minimal which means that any capital sum received for the grant of a licence.

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- Acquisition of intellectual property occurs either when the property was created (eg. Copyright), or originally conceived (eg., patents), or when the contract was entered into if the property was transferred pursuant to a contract.

CGT Measures

Of particular interest to the intellectual property industry are the reform measures dealing with capital gains tax (“CGT”) measures for small business and also those changes for assets held by individuals.

In summary:

An active asset (ie., an asset used in conjunction with the conduct of a business) held by a taxpayer whose net CGT assets are less than \$5 million, can access special CGT concessions. The concessions include:

- (i) 100% exemption if the asset has been held for more than 15 years;
- (ii) 50% reduction of the CGT gain;
- (iii) offset the CGT gain against the cost of replacement asset; or
- (iv) apply some part of the proceeds to fund the retirement of the owner of the asset or a individual controller of a company or trust.

An individual who has held certain types of assets for more than 12 months is also allowed a 50% reduction of the CGT made on the disposal of an asset. (Capital proceeds for the partial realisation of an asset are not subject to this concession)

Special Income Issues

Royalty income is taxed as income, as with most countries in the world. The definition of a royalty is exceptionally broad, and special advice should be sought before embarking on any licence arrangement.

Where the payment of a royalty is made by an Australian entity to a foreign intellectual property owner, a withholding tax will be deducted from the payment at generally 10%. However, great caution needs to be exercised as regards the establishment of the royalty rate. The Australian Taxation Office (“ATO”) stringently polices Australia’s transfer pricing rules. Attempts to shift profits from Australia via the payment of excessive royalties or licence fees is a common target for the ATO

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Balance Sheets

Australia, like many other countries are currently engaged in an accounting debate dealing with the reporting of intellectual property. As part of Australia's attempt to globalize financial reporting, IAS 38 is presently being considered by the respective accounting bodies in Australia. If this International standard is adopted by the Accounting bodies the direction of that accounting standard will form part of Australian corporate law.

IAS 38 proposes that internally generated intellectual property can only be revalued in balance sheets if there is an active market for that intellectual property. This is of course a nonsense, as the very nature of the value of intellectual property is its novelty.

A further concern arising from this international accounting standard is its pronouncements concerning the amortisation of acquired intellectual property and the write of research and development expenditure. The practical effect of both of these requirements will be the reduction of reported profits, without proper regard to the longer-term benefits attributable to novelty and invention.

From a practical perspective, the contradiction not all that apparent to those arguing for IAS 38's adoption is that, on the one hand they argue for more informed financial data being made available to shareholders and other interested stakeholders and yet on the other, they wish to restrict the publication of relevant information concerning emerging assets of the new economy – intellectual property.

Unfortunately the debate has not being universally adopted by business. Innovators talk about it, academics know about it, small business could care less and accountants are not trained to deal with it.

The huge abyss caused by the lack of accounting training on the subject matter of intellectual property is a subject matter of some longer term concern and needs to be addressed. At a minimum, the profession needs training in the following areas:

1. Knowledge of the different types of intellectual property;
2. Measurement and valuation methodologies; and
3. Risk appraisal techniques.

This debate should not be left to the auditing profession, they have their own inherent risk protection techniques!

Valuation

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The methods adopted to value intellectual property in Australia are no different to other countries. Use of discounted cash flow analysis, comparable value methods are the most common adopted, however for those experienced in dealing with intellectual property on a world stage it should be appreciated that:

- (i) Australia has no NASDAQ equivalent and accordingly, reference to Australian public valuation ratios and multiples are not applicable;
- (ii) Australia's venture capital market is still immature with the consequence being that developed venture capital norms are not readily available; and
- (iii) Australia has a small domestic market and accordingly the true value of intellectual property must be considered on a broader geographic market. This raises significant commercial difficulty for the owners of intellectual property properly assessing the worth of their property.

How to form a Joint Venture

Apart from the precise assurance of the ownership of the IP, four (4) other issues must be addressed, in the Joint Venture Agreement namely:

- that the original commercial objective which brought the participants together in the first instance. This is what's called the "Scope of the Venture", within which spectrum all available IP will be assigned to the holding company;
- the methods by which the vehicle will be administered – how are decisions made, who prepares the accounts, who signs the cheques – all matters about which the standard company constitution or trust document are generally silent;
- identify the personal responsibility of each participant in the joint venture towards achieving the Scope of the Venture – ensuing participation is linked with actually delivering the promised personal contributions.
- finally, how the shares of each participant are actually sold – perhaps the most critical alteration to the standard trust deed and Memorandum and Articles of Association of the company.

Let us examine each in turn.

The Scope of the Venturers

The '**Scope of the Venture**' is the legal term for the commercial goals which the Business has been formed to single-mindedly pursue, thereby determining the commercial spectrum

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within which the various partners must exclusively operate with each other and outside of which they have freedom to act on their own account.

Unless every director agrees, there can be no changes of commercial direction by the majority of the Board. Even a minority board member can veto a decision by the Board majority to use its resources for purposes other than that originally intended in the Scope. Of the venture

The ‘**scope of the venture**’ also clarifies:

- IP rights transfer, and
- the trade restraint provisions which will operate when one of the joint venturers leaves the venture.

The departure of key individuals could damage your venture’s future survival prospects unless each venturer assigns all their IP to the holding vehicle and within the Scope of the Venture.

The Scope is cross referenced with of the IP – ensuring that all IP created at the time and from time to time by any of the participants within the Scope of the Venture belongs to the holding vehicle at all times.

The prudence of adopting post termination restraint is borne out by the story of Saatchi & Saatchi the advertising group founded by brothers Charles and Maurice in 1970. It ultimately became one of the largest professional services groups in the world. However, by 1988 the group was in financial chaos with significant losses, due primarily to the loss of creative talent. In 1994 Maurice Saatchi resigned as the Chairman of the firm which by then had billings of \$7.5 billion, and had been renamed, in this process of growth, Cordiant. Determined to succeed where his former Business was beginning to fail, Maurice started a new agency with his brother Charles and began to compete. Cordiant lost \$40M of Business (6% of total billings), much of which including such major accounts as British Airways and Dixons, went to the brothers new agency M & C Saatchi. The managers who had ousted Maurice could only watch in dismay as the value of their company plunged to barely 2% of its peak market capitalisation attained in 1988.

- Thirdly, fiduciary duties apply between the directors, shareholders and the company and within the Scope of the Venture. These fiduciary duties are not normally owed to each other by shareholders individually. These duties mean that a participant cannot take advantage of their participation in the venture for their own gain and over the agreed interests of their other partners.

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As the enterprise develops, new corporate missions and goals may be adopted within the Scope of the Venture to progress project goals. These changes fall within the provisions of the Business planning process, which are also adopted in the Joint Venture Agreement.

Ensuring Contributions are Maintained

Individual contributions to the Scope of the Venture must be sought, agreed and recorded from each participant. Carefully considered job specifications will ensure the partners' ongoing commitment to the Scope of the Venture.

These specifications underwrite those individuals retaining their equity holding in the company. If those contributions are not effectively made throughout the life of the project, then the non-contributing party's shareholding is valued and sold, most probably to the remaining venturers and according to a prearranged formula set out in the Agreement. For example, if Toby, in the D-Load case study, started channelling improvements through another company without Sarah and Larry, he could be censured and if this were to continue, he could be evicted.

Allocating equity in the trading vehicle may be part of the remuneration package for key employees. Given the taxation implications, employee share schemes may be of advantage. The Corporations Law allows and provides for employee share schemes. When their employment ends, either voluntarily or otherwise, their shares are valued and acquired by the ongoing venturers or re-acquired by the actual company or trust. In such situations, shareholdings do not endure beyond employment.

Often the Scope of the Venture and other aspects of corporate strategy in IP start-ups is determined by individual competencies of participants and key staff. The founding directors are the only human resources the start up Business can afford, because the promoters forego wages in return for equity in the venture.

Once the Business Plan has identified those key competencies required by the enterprise in order to prosper, the legal structure ensures they will be provided by the original venturers.

This concept of accountability for commercial performance by participants is alien to Australian notions of share and unit holding under the Corporation Law and Trust Law. Without a preliminary contractual agreement to assume these responsibilities voluntarily, only a court could otherwise impose this responsibility – and then only after a slow, expensive court case brought by a disgruntled co-shareholder. You need to ensure you have specific contractual provisions in the joint venture to achieve this outcome without need for a court case.

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The critical value of the skill contributions by each participant will generally determine that person's equity allocation in the companies which are the corporate vehicle. Such percentages are reached through negotiation, for which there are no hard and fast rules. The allocations are generally the result of negotiation between participants at the time – a critical preliminary decision.

In the D Load Case Study, for example, the venturers need to rationalise their contribution to the company they can follow an outline such as this:

PARTICIPANT	SOFTWARE	EQUITY
Toby	Software	40%
Sarah	Marketing	40%
Vantek	Venture Capital	20%

Providing for Predictable Management Outcomes

In the D-Load example, each active participant has as many as three distinct, though simultaneous roles, namely:

- equity holder – as a shareholder
- director – as a member of the board approving key management decisions
- executive – as a day-to-day employee of the Business.

Each of these roles needs to be carefully clarified when decisions are being made on behalf of the Business. For example:

- As a shareholder, the participant can vote and act in self interest, although this changes once fiduciary duties are assumed.
- As a director, the participant has a responsibility to the overall Business and its continuing improvement to generate returns and must act in the company's best interests to the exclusion of his/her own aspirations.
- As an executive, the participant must make decisions about the nature of the day-to-day work in the company's interest, which often involve external parties who don't have your company's interests at heart. The directors, the manager must prefer the company's interests to his/her own.

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Confusion or resentment about how decisions are made is a common ground for disputes and hence management paralysis. To avoid potential disputes, decision-making schedules should be settled by the shareholders in advance and recorded in the Joint Venture Agreement. These should determine how each decision should be made.

Decisions fundamental to the conduct of the Business should be implemented only if made unanimously and probably within the context of an Extraordinary General Meeting of Members. This enables a minority shareholder, to veto a decision which has been judged to be critical to the Business. Veto rights do not enable the minority shareholder to control the decision making, just block certain decisions about management fundamentals.

Such veto provision will inevitably reactivate the negotiation process which may well solve the objections of the corroborative shareholders (ie general shareholder meetings and board meetings).

Similarly, appropriate arrangements can be made about the calling and conduct of board meetings as well as the circulation of regular financial information about the Business performance. Having a guarantee of regular current information about the financial performance of the Business enables everyone's investment to be carefully monitored.

Introduction and exit of venturers

An entrepreneur ought not get into an entrepreneurial project without knowing how:

- to get out of it; or
- to evict one of his/her co-partners whose acts or omissions threaten the survival of the Business

Departure, having received the value of the originally acquired shares, is an ever present option for the original promoters. Predictable processes to achieve this departure "fully paid up" is another critical aspect of the Joint Venture Agreement. This avoids applications to court to evict recalcitrant or non-performing shareholders. Indeed, in terms of the amount of boilerplate in the actual Joint Venture Agreement, it is the exit provisions which make up the largest section .

Without precise exit provisions, courts are reluctant to evict non-performing or rogue shareholders who are in breach of their original promises. Only an exact specification of the procedures will be followed and including of share valuation. Such provision enables a court to grant:-

- a mandatory injunction; or

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- allow the exiting parties to operate under an allied Power of Attorney and thereby direct the departure of an evictee.

Eviction procedures should involve paying the shareholder for shares on a prearranged basis. Indeed, by using such provisions, few disputes ever find their way into court. It is likely that if a disgruntled shareholder is evicted – and paid – in accordance with procedures that shareholder adopted in advance – then the departed is most likely to abide by those arrangements. Why fight? Better to take the payout, and start again free of the aggravation of a personal and commercial relationship which has failed to remain collaborative.

Carefully thought out exit provisions are essential for venture capitalists who, immediately after their actual investment, are looking to the day when they can liquidate that investment and realise their profit. Since the venture capitalist's return is through capital gains on the on-sale of their shares, the exit mechanism is critical.

Over the past few years, life insurance companies have also developed a series of innovative policies which provide for payouts triggered by the:

- death; or
- total and permanent disability,

of a key shareholder in a Business. In those events, and through well drafted “succession clauses”, sensitive to the income tax implications, the shares of the deceased shareholder are:

- transferred to the remaining shareholders; whilst
- the estate of the affected shareholder receives the insurance payout.

Alternatively, key man insurance provisions will ensure the actual Business vehicle ie the company or trust (rather than the ongoing shareholders) is the beneficiary when an employee or participant, crucial to the Business performance, dies or is incapacitated.

Who owns the Intellectual Property

IP rights created by the various participants prior to or during their participation in the project:-

- must be automatically transferred (re “vesting”);
- to the entity holding the IP; and

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- as soon as these rights are conceived by the respective authors.

Without formal assignment, participants who develop the IP rights will retain certain rights personally rather than IP ownership vesting in the holding company. Intellectual Property Law does not co-ordinate with Company Law. Contractual modifications can create the appropriate alignment. IP assignment provisions are generally linked with post-departure restraint provisions accepted by each participant, ensuring that each shareholder and/or director, on his or her departure, affords the company a period during which they will not compete with the Business within the Scope of the Venture.

Getting the Job Done - Project Management Skills

Overseeing the complementary inputs from a series of otherwise disconnected professionals to acquire one of these specialist structures requires strong management skills on the entrepreneur's behalf.

Planning and close supervision of each step is essential. Enclosed are the agendas for the meeting in the D-Load Case Study – and the final meeting. Each entrepreneur must become an effective consumer of professional services. Knowing precisely the outcome required is also necessary as these kinds of structures are not as yet widely known nor used throughout Australian Business. Only about 5% of Businesses have any such arrangements in place – accordingly, there are insufficient role models to inspire thought on these issues.

The Action List set out in Schedule 5 of the annexed Joint Venture Heads of Agreement sets out the sequential steps required to achieve the appropriate structure. Choose advisers already experienced in IP driven Business willing and able to work together in a predictable, focused and multi-disciplinary manner.

Action list for adoption of joint venture

In the context of the D Load case study, annexed are:

- an Action List (as Schedule 5 of the Heads of Agreement) – showing the sequential steps to be taken by the respective participants to this process. Maintaining, updating and constantly circulating this Action List during the process will help in coordinating your professional team. By asking the professionals to 'price' each step, that is put a "fee cap" value on it, the entrepreneur can more efficiently identify in advance and manage the cost of the overall adoption program. It is handy to give the Action List additional impact by its inclusion in the Heads of Agreement.
- the Agendas for both the first briefing meeting and final drawdown meeting are also annexed . These are handy for maintaining control of the briefing process and

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avoiding being sidetracked. By keeping minutes of the discussions at these meetings you can cross reference what you actually discussed and agreed at the meetings and build these resolutions into your Agreements;

- an example of a Heads of Agreement for an IP driven Joint Venture Agreement. These Heads of Agreement provide a pre-contractual “mud map” of the five main commercial aspects of the proposed actual “boilerplate” Joint Venture Agreement. Adopting such a clarificatory and preliminary platform early in the negotiation process will provide an effective basis for briefing your lawyers when the longer, more complex “boilerplate” provisions of the actual Joint Venture Agreement – capable of court enforcement – is required;
- a diagram of the overall two company structure – clearly setting out the relative positions of all the participants and the vehicles. This is a helpful tool for everyone understanding the final Joint Venture Agreement.

Remember, a lawyer cannot act for more than one participant in a commercial transaction. To do so may well be an actual or potential conflict of interest for the lawyer and potentially expose the lawyer to some form of professional discipline if not lawsuit from a disgruntled client. Each of the participants to the proposed structure is likely to have actual divergent interests.

So accordingly, the organising lawyer is best positioned to act on behalf of the holding company, (ie.) the entity owning the IP and then on-licensing the IP to the trading vehicle.

All the other participants (generally each separate director or shareholder) will have their own separate advice from another lawyer who acts for them alone in their shareholding capacity. This reduces the prospect of any one shareholder not getting separate advice. Lawyers rules about conflict of interest apply less strictly to Business planners, accountants and patent attorneys – in which case one such professional can generally act in everybody’s interest.

- The lawyer documents the arrangements;
- The accountant ensures the assignments and other transaction and aspects of the commercialisation of IP rights are "revenue sensitive" - from the perspective of both capital gains tax and stamp duty dealing with the balance sheet and valuation issues.
- The patent attorney identifies those elements of registrable IP and makes the appropriate registrations before the application, in the case of a design and a patent, is prejudiced by there disclosure to the market place.

Each of these distinct professional contributions must be identified, prioritised, allocated and costed. All participants including the chosen professionals must work together sensitive to the

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job being performed by the other participants in the process. Accordingly, and by getting costs for each step from each contributor, the entrepreneur will know who is doing what, when and how much it is all likely to cost.

Ideally the process should have a coordinator (you, as entrepreneur, are probably the best person to do this) who keeps overall objectives in mind as respective contributions are addressed, completed and communicated to the other members of the project.

Each of the respective advisers within the team performs a different function to achieve the desired corporate structure. The following chart looks at each of these respective professional functions.

LAWYER	ACCOUNTANT	PATENT ATTORNEY
<ul style="list-style-type: none"> ➤ Identify the elements of IP rights in the project: <ul style="list-style-type: none"> ➤ patent ➤ trade mark ➤ design ➤ copyright ➤ information ➤ goodwill ➤ Help choose the trading and holding vehicle. ➤ Help choose the type of entity by which the various participants will hold equity in the project (e.g. family trust, XX) ➤ Ensure the IP rights are assigned into the holding entities. ➤ Assess the consequences of stamp duty on the internal movement of IP and external commercialisation of IP. ➤ Ensure the appropriate licence between trading and holding entities is in place. 	<ul style="list-style-type: none"> ➤ Help choose entities for the trading and holding structures – with tax consequences in mind. ➤ Identify capital gains tax implications of transferring IP rights from the authors into holding entity. ➤ Conduct your Business planning. ➤ Identify research and development tax deductions in relation to each project. ➤ Do your tax planning for both vehicles. ➤ Set the holding company's rate of return to license the IP rights to trading company. ➤ Advising our balance sheet issues – how to characterise the instinct types of IP in the company's book of account. 	<ul style="list-style-type: none"> ➤ Identify the project's patent design and trade mark prospects. ➤ Conduct searches of prior art and prior trade marks. ➤ Apply to register the patent design and/or trademark and confirm registrations.

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<ul style="list-style-type: none">➤ Draft both the heads of agreement and actual joint venture agreement documents to suit your client's particular IP product and Business.➤ Ensure all elements of "due diligence" are completed.	<ul style="list-style-type: none">➤ Identifying the preliminary values of assets – and their increase in value as commercialisation begins.➤ Advice on the GST implications of the set up procedure and the ongoing relationship.	
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Rewire the corporation

Conventional organisational models do not suit IP based venture capital financed Businesses, especially those anticipating the adoption of Venture Capital. Joint Venture Agreements provide a self-correcting legal structure that helps manage the predictable difficulties in commercialising Intellectual Property. This legal structure demonstrates an understanding of how "the game is played". The five different factors all work together, often playing off each other. The politics of these start up Businesses are thus given a predictable set of rules which everyone knows and accepts and before any problems arise. Uncertainty and vagueness are the enemies of the entrepreneur especially in managing potentially volatile relationships. Such anticipation will hearten the venture capitalist who won't have to educate the promoters before restructuring the Business as a precursor to the actual venture capital investment.

The Entrepreneur must seek from his/her professional advisers outcomes which adequately reflect the creativity and dedication which the Entrepreneur would have mustered to develop the new product or service which she/he is seeking to commercialise. The professional advisors must accept the challenge of adopting reformative legal structures in line with worlds best management and professional practice. Such arrangements may, at first glance, feel strange, even illogical, but they enable the Business to be entrepreneurial using "other people's money". They also allow it, contractually, to cope with hot issues before the issues become disruptive of the Business.

John Kenny
KENNY & CO
john@entrelaw.com

Brian Richards
BDO Kendalls
Brichards@bdokendalls.com.au

Dated this day of 2000

Between: **TOBY BUZZCOCK**

and: **SARAH SMOOZE**

and: **SARAH'S FAMILY TRUST**

and: **LARRY BIGBUZZ**

and: **D LOAD TRADING PTY LTD**

and: **D LOAD HOLDINGS PTY
LTD**

**D LOAD
SHAREHOLDERS AGREEMENT**

File name & path

Version.....

Date

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These **JOINT VENTURE HEADS OF AGREEMENT** are made this day of
2000.

between **TOBY BUZZCOK** of [*INSERT ADDRESS*] in the State of Queensland
("Toby") of the first part

and: **SARAH SMOOZE** of [*INSERT ADDRESS*] in the said State ("Sarah") of the
second part

and: **SARAH'S FAMILY TRUST** of [*INSERT ADDRESS*] in the said State
("SFT") of the third part

and: **D LOAD TRADING PTY LTD** of [*INSERT ADDRESS*] (ACN 000 111 222)
in the said State ("Trading") of the forth part

and: **D LOAD HOLDINGS PTY LTD** of [*INSERT ADDRESS*] (ACN 111 333
222) in the said State ("Holdings") of the fifth part

and: **LARRY BIGBUX** of [*INSERT ADDRESS*] in the State of New South Wales
("Larry") of the sixth part

and: **VENTEK PTY LTD** of [*INSERT ADDRESS*] (ACN 999 111 876) in the said
State ("Ventek") of the seventh part

WHEREAS

- A. Toby developed the Software and owns the IPR. Sarah has considerable experience both in Australia and the UK in popular music journalism. Toby and Sarah have assigned the IPR to Holdings.
- B. Ventek is the business of providing venture capital.
- C. Sarah, Toby and Ventek are shareholder through the Entities to operate a Joint Venture to pursue the Scope of the Venture. Sarah and Toby have assigned their IPR to Holdings.
- D. Sarah will hold her Shares through SFT. Ventek will hold its shares in their own name, as will Toby. Each of Larry, Sarah and Toby are directors of Holdings, but Larry is not a director of Trading.
- E. Holdings shall be one of the Entities and will hold the IPR, which will be licensed to Trading.

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F. Crabshaw Solicitors act on behalf of Venquest. All other parties have been encouraged and afforded the opportunity to obtain independent professional advice.

NOW THESE HEADS OF AGREEMENT WITNESS that the parties agree to use their best endeavours to speedily negotiate and settle a Joint Venture Agreement in accordance with the timetable in Schedule 5 and the diagram in Schedule 6 and the General Conditions and Schedules to these Heads of Agreement.

EXECUTED as a Heads of Agreement on the date referred to above.

SIGNED by **TOBY BUZCOX**)
personally and on behalf of)
D-Load Trading Pty Ltd)
in the presence of:-)

.....
Witness

SIGNED by **SARAH SMOOZE** personally)
and for and on behalf of **SARAH'S**)
FAMILY TRUST in the presence of:-)

.....
Witness

SIGNED by **LARRY BIGBUX** personally and for)
and on behalf of **VENTEK**)
PTY LTD and **D LOAD HOLDINGS**)
PTY LTD in the presence of:-)

.....
Witness

File name & path
Version.....
Date

GENERAL CONDITIONS

1. SCOPE OF THE VENTURE

1.1. The Venturers (i.e. all parties to the Joint Venture other than the Entities) agree to operate an incorporated joint venture through the Entities in the World for:-

- (b) the commercialisation of the Software;
- (c) any other project the Shareholders unanimously decide.

1.2. In respect of the Scope of the Venture, the Venturers will:-

- (a) confine to the Entities their respective activities concerning the Scope of the Venture; and
- (b) refrain from any activity in competition with the Entities either directly or indirectly.

2. CONTRIBUTIONS

2.1. As a basis for their respective involvements in the Joint Venture, Sarah and Toby shall contribute their complimentary skills towards the Scope of the Venture in the manner set out in Schedule 1 and Schedule 2 respectively.

2.2. The Contributions may be amended from time to time by unanimous decision of the Shareholders.

2.3. The Venturers acknowledge their participation in the joint venture and their respective shareholding is dependent on their respective ongoing proper provision of their Contributions as defined herein.

3. ADMINISTRATION

3.1. During their respective Terms, each Venturer acknowledges and agrees:-

- (a) the administration of the proper outgoings of the Entities shall be administered by Sarah who PROVIDED ALWAYS that all cheques will be signed by any two directors, and
- (b) the Entities shall conduct their bank account as directed by the Board at the time.

3.2. The Financial Accounts of the Entities will be prepared by Sarah on a monthly basis and forwarded by email to each Director and the Accountant including:-

- (a) previous months profit and loss accounts and balance sheet;
- (b) subsequent months cash flow projections;

which records shall be circulated no later than seven (7) days of the conclusion of each month.

3.3. A meeting of the Board of Directors shall occur not less than once during every consecutive calendar month or after giving two business day's notice.

3.4. All periodic secretarial and administrative tasks of the Joint Venture shall be overseen by Sarah as required at the time and from time to time at the expense of the respective Entities

3.5. All Decisions referred to in Schedule 3 shall be made by all shareholders unanimously at an Extraordinary General Meeting.

4. RIGHTS

4.1. Each Venturer hereby assigns to Holdings their IPR in respect of the Scope of the Venture.

4.2. All Venturers shall give all information to the Entities concerning the Scope of the Venture.

5. EXIT

[Refer to Schedule 4].

6. RESTRAINT

6.1. Upon termination of their respective involvement within the current joint venture for whatever reason, the Venturers undertake to the Entities and each other as follows namely:-

- (a) not to compete with the Entities directly or indirectly within the Scope of the Venture; or

(b) represent any other person in relation to activities within the Scope of the Venture;

for a period of not less than two (2) years from the date of termination in any territory or country of the world.

6.2. The Venturers accept the reasonableness of these restraints.

7. INTERPRETATION

Accountants	the accountants of the Entities at the time and from time to time who in the first instance shall be Quartermass Partners, Geebung;
Directors	the directors of Holdings and Trading;
Entities	each and every one of Holdings and Trading;
IPR	those rights of intellectual property in the Scope of the Venture at the time and from time to time;
Joint Venture Agreement	that agreement to be negotiated and executed by the parties in accordance with these Heads of Agreement;
Software	the D Load software developed by Toby to reduce and eliminate virus transfer with the down load of music from the internet;
Secretary	the Secretary at the time and from time to time of the Entities, who in the first instance shall be Sarah;
Term	that period of time during which a shareholder holds shares in the Entities;
Venturers	all Directors and Shareholders at the time and from time to time;
World	all countries and territories of the world.

SCHEDULE 1

CONTRIBUTION OF TOBY

1. Planning and conduct of ongoing research and development in relation to the Software.
2. Maintenance of the web site.
3. Hiring and overseeing of the research and development unit of Trading.
4. Acting as guarantor on the overdraft.

SCHEDULE 2

CONTRIBUTION OF SARAH

1. Provision of working capital for the Scope of the Venture.
2. Marketing of the Software on the internet especially product launches.
3. Public Relations for the company.
4. Acting as guarantor on overdraft and leases.
5. Provision of working capital.

SCHEDULE 3

UNANIMOUS DECISIONS OF AN EXTRAORDINARY GENERAL MEETING

1. Allot additional shares.
2. Change name of the Entities of the Software.
3. Merge the business with that of another person.
4. Issue a mortgage.
5. Wind up the Software.
6. Appoint a receiver.
7. Grant a guarantee.
8. Issue a Power of Attorney.
9. Cease business.
10. Cancel a debt of the Entities.
11. Make an investment.
12. Amendment of Contributions from time to time.
13. Additional working cotter.
14. Development of projects other than the Scope of the Venture.

SCHEDULE 4

ALTERNATIVE EXIT MECHANISMS

OPTION 1

(Remaining shareholders either buy-out the Outgoing Shareholder or vice versa.)

5.1 Should a Venturer wish to sell their shares or be obliged to do so pursuant to the terms of the Joint Venture Agreement, then the following sequential procedure will be followed, namely:-

- (a) the Outgoing Shareholder will place a price per share on his/her shares (the "Price") and offer their shares to the Remaining Shareholders at the Price;
- (b) the Remaining Shareholders will have fourteen (14) days from the date of the offer set out in sub-clause (a) (the "Offer") to accept or reject the Offer;
- (c) if the Remaining Shareholders accept the Offer they must purchase the Outgoing Shareholders Shares at the Price;
- (d) if the Remaining Shareholders reject the Offer or fail to respond to the Offer within fourteen (14) days then the Outgoing Shareholder must purchase the Remaining Shareholders' Shares at the Price.

OPTION 2

(Series of offers the Outgoing Shareholder must make.)

5.1 Notwithstanding the foregoing, and in the event a Shareholder wishes to sell his/her shares, he/she shall offer them at their own price to:-

- (a) the remaining Shareholders in their respective proportions;
- (b) the extent all shares are not thereby acquired, to the remaining Shareholders out of proportion to their Shareholding; and
- (c) the extent any shares are still thereby available, the Shareholder may sell them to a third party provided that person is not a competitor of the Company and acceptable to the remaining Venturers.

5.2 In the event a Venturer is in breach of their obligations under the Joint Venture Agreement and within seven (7) days of notice in writing such breach is not corrected, they can be evicted as a Shareholder in which case the abovementioned sequence of share offers set out in Clause 5.1 will occur.

SCHEDULE 5

Action	Person/s responsible	By when	Estimate
1. Meeting 1 (see Agenda below).	Accountant Business Manager Lawyer Sarah, Toby, Larry	ASAP	
2. Acquire both holding and trading entities and allocate shares to appropriate entities of the participants in appropriate percentages.	Accountant Lawyer	+ 1 day	
3. Assignment of the IP to holding company, and licensing the IP from holding company to the trading company – two separate documents.	Lawyer	as in 3	
4. Register trade mark, patent, designs in the name of the holding company.	Patent Attorney Lawyer		
5. Sign Assignment and Licence.	Sarah, Toby	+ 2 days	
6. Amend Heads of Agreement.	Lawyer	+ 2 days	
7. Sign Heads of Agreement.	Sara, Toby, Larry	+ 1 day	
8. Draft Joint Venture Agreement.	Lawyer	+ 5 days	
9. Feedback.	Business Manager Lawyers	+ 5 days	
10. Amend and circulate Joint Venture Agreement with changes to the articles of association of the companies.	Lawyer	+ 5 days	
11. Drawdown meeting (see Agenda).	Lawyer Business Manager	+ 2 days	

SCHEDULE 6

INSERT DIAGRAM OF THE CORPORATE STRUCTURE