DEAL POINTS SHORT TAKES 2021.03: ALLOCATE RIGHTS AND RESPONSIBILITIES EARLY IN COMPANY LIFE TO AVOID TROUBLE LATER AND CREATE A VIABLE INVESTMENT VEHICLE

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Deal Point: Fully organize your company and allocate rights and responsibilities early to promote harmony among the founders and be a viable investment vehicle.

Explanation and Takeaways

It can seem like a waste of time and money, and even an indication of mistrust among colleagues. It's not. In the early stages of forming and organizing a new business enterprise, negotiating and documenting the founders' and early-stage investors' rights and obligations is one of the most vital tasks to front load, and there's a reason for that which escapes most entrepreneurs: yes, it is easiest to set down and assign those rights and obligations when everyone is happy with each other and before any disputes arise over whose contributions have been worth more, who has worked harder, and so on. But more than that, doing so actually *promotes harmony* within the company thereafter; when all parties know from the outset, without ambiguity, what they have a right to expect and, more importantly, what they *don't* have a right to expect, they tend not to demand things to which they have no right. Those kinds of disputes are less likely ever to emerge. And, for disputes that do flare up, if there is a clear and mandatory answer or roadmap to resolving them that everyone signed on to at the beginning, those disputes will likely be settled faster, less expensively, and less disruptively. Finally, it is work that will have to be done anyway before any investor will seriously look at the company.

The allocation of rights and obligations among founders and early stage investors can be assigned in a variety of documents. In a corporation, it may be a combination of a certificate of incorporation, bylaws, and a shareholders agreement. In a limited liability company (LLC), it may be in the LLC Operating Agreement, or LLC Agreement, as it is variously called. In a partnership or limited partnership (LP), it is in usually the partnership agreement. It may be in one or more separate agreements, like an investment agreement, a joint venture agreement, an intellectual property license or assignment agreement, or a creditors' agreement. Wherever set down, rights and obligations of founders and early investors to establish early should include:

- **Attributes of Ownership Interests** (classes and series of common and preferred stock in a corporation, with rights to profits and losses, liquidation, redemption, conversion and other preferences; the equivalents are membership interests in an LLC and limited partnership interests in an LP);

- **Contributions of Capital, Intellectual Property Rights and other Assets**, what equity or debt they are given in exchange for, and rights to reacquire them if the company does not succeed;

- **Salary, Royalties or other Compensation** to provide cash to founders and reduce tax liabilities;

- **Board of Directors and Officer Participation** among founders and investors, establishment of voting rights, including major decisions requiring supermajority votes or veto rights;

- **Preemptive (anti-dilution) Rights** to give existing equity holders the right to buy in to new financing rounds to maintain their *pro rata* share of ownership (they generally do not exist if not expressly granted);

- **Voting Agreements** to elect Board members, approve business plans and facilitate other company business;

- **Ownership Transfer Restrictions and Buy-Sell Rights** to regulate what happens if somebody wants out;

- **Registration Rights** to give equity holders, particularly minority shareholders, the right to participate, *pro rata*, in sales of the company's equity or to participate in a public offering; and

- **Restrictive Covenants and Noncompetition Agreements** to prevent a founder or investor from leaving the company and immediately going into competition against it.

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