# POWERSHARING: ALLOCATING RIGHTS AND RESPONSIBILITIES EARLY IN COMPANY LIFE TO AVOID TROUBLE LATER AND CREATE A VIABLE INVESTMENT VEHICLE

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## I. Executive Summary

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 to each other 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 prospective 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 in a combination of a long form corporate certificate of incorporation (which requires a formal amendment to change, but which also make certain matters more formal, and less frivolously opposable), bylaws, a shareholders agreement, and a registration rights 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, it is in usually the partnership agreement.[1] It may be in one or more separate agreements, like an investment agreement, stock option or other equity participation agreements, a joint venture agreement, an intellectual property license or assignment agreement, or a creditors' agreement.

[1] The decision of whether to form a business as a corporation, LLC, limited partnership or other business entity is outside the scope of this advisory, but is influenced by tax and other considerations, including the 2017 Tax Cut and Jobs Act, aspects of which may be modified or repealed by the new Biden administration. Those considerations are discussed in our "Inbound & Startup and Virtual General Counsel Legal Services" brochure and "Tax Influenced Strategies for End-of-Year Deals" and "International Joint Venture Agreement Checklist" advisories, all available at https://kurtinlaw.com/articles-whitepapers/ or on request to info@kurtinlaw.com.

II. The Most Critical Rights and Obligations to Document Early

a. Attributes of Ownership Interests. Typically, common stock ownership interests, general partner interests in a general or limited partnership, and common LLC ownership "membership interests" will be similarly situated to one another, share in profits and losses *pro rata*, and have voting rights commensurate with their ownership interests. However, ownership interests of preferred stockholders, convertible debt instrument holders, limited partners, and holders of preferred LLC membership interests may have preferences in payment upon liquidation, preemptive or anti-dilution rights, conversion rights, special voting rights, board and/or committee representation and other rights (see below for more detailed discussions). Additional equity interests can be offered in stock option or other deferred or contingent compensation, often tax-advantaged and useful to early stage companies seeking to defer cash payments. In Delaware, the most popular U.S. domicile for corporations with multistate or multinational operations, these attributes must generally be expressly provided for in the certificate of incorporation, which must be filed, along with any amendments or restatements, with the Delaware Secretary of State.

b. Contributions of Capital, Intellectual Property Rights, and Other Assets. The circumstances under which the company can make post-initial investment capital calls on founders and investors should be set forth in founding documents. If any person is contributing non-cash capital, be it intellectual property, services or "sweat equity," stock, or other assets, the terms of that contribution and its valuation in the initial valuation of the company should be established at the outset. As part of the exercise, the rights to use all intellectual property, whether patent, copyright, trademark or other, should be clearly established, and all assignments, licenses, and similar rights-granting contracts should be put in place if not already done, with particular attention to their exclusivity, scope, royalty or other fee basis, term, and assignability. The rights to reversion of contributed capital, intellectual property, and other assets should also be established, including their priority, subject to outside creditor and other senior rights. Section 365(n) of the U.S. Bankruptcy Code (11 U.S.C.), permitting the licensee of intellectual property (i.e., the company) to elect to maintain executory license rights in the event of the licensor's bankruptcy, should be considered.

c. Salary, Royalties or other Compensation to Reduce Tax Liability. The founders may not be similarly situated not only in their capital and other asset contributions, but in their day-to-day efforts on behalf of the company. For example, it is common for one or more founders to operate the business on an ongoing basis, and for others to have contributed capital, intellectual property or other assets, and to be essentially passive in their post-investment activity. The founders should consider whether some of the active founder's or founders' compensation should be paid in the form of a salary pursuant to an employment or consulting contract, with stock option or other equity-based compensation added in consideration of hitting business plan milestones. Payment of some founder compensation in the form of salary not only provides a means of living for a non-capital investing founder, but effectively "converts" some profits to a fee or salary, which reduces the company's bottom line profitability, and often tax liability. A similar benefit can be obtained by granting a royalty-bearing license to a founder contributing intellectual property to the company in exchange for the other founders' investment.

d. Board and Officer Participation; Voting Thresholds. Rights of parties to nominate members of the Board of Directors or equivalent governance organ and officers should be carefully considered. The division of Board voting rights into simple majority rule for routine matters, "supermajorities" for more exceptional corporate events, and even in some cases unanimity, effectively giving each Board member a veto, or actually naming a Board member who has a veto, for the most exceptional corporate events, should be considered. In general, too great a requirement for unanimity or supermajority can paralyze ordinary corporate action that should not require unanimity or a supermajority, while permitting everything to be done by simple majority can allow ill-thought out corporate actions to take place, often to the prejudice of equity holder minorities.

e. Preemptive (Anti-Dilution) Rights. The right of existing equity holders to buy in to new financing rounds to maintain their proportionate, *pro rata* share of ownership should be considered.[2] While founders may often accept dilution of their equity to in effect have a smaller piece of a larger pie, providing for these rights can often improve the valuation of the company even when the rights are not exercised. In Delaware and many other jurisdictions, preemptive rights only exist when they are expressly granted, and must be expressly provided for in the filed certificate of incorporation or any amendments and restatements to it in the attributes of the class of shares to which they pertain.

f. Voting Agreement. Any convention by the equity holders to vote their interests to elect Board members, officers, approve a budget, business plan, by-laws, financing events, critical contracts,

[2] See our "Raising Capital through Private Placements: Deal Points" advisory, available at https://kurtinlaw.com/articles-whitepapers/ or on request to info@kurtinlaw.com.

etc. should be set forth. In its absence, such leverage can be used to block and paralyze corporate action, for (one possible) example, by an equity holder who wants to sell the company against other equity holders who want to continue to operate and grow it. This kind of provision is often set forth in a shareholders agreement or equivalent document.

g. Ownership Transfer Restrictions; Buy-Sell Rights. What happens if somebody wants out? Restrictions on transfer imposed by U.S. or other applicable securities and tax laws should be reviewed and set forth. Any other regulatory restrictions should be considered, as well: companies engaged in certain kinds of business, and especially holding certain licenses, may have foreign ownership restrictions, restrictions on ownership by persons with criminal records, restrictions on export of sensitive technologies, and restrictions on foreign investment.

More conventionally, even if none of those issues is relevant, a company may want to provide for rights of first refusal and/or last offer by other equity holders when an equity holder receives an offer to purchase his interest and the procedures to be followed in such a case. Also, the parties may want to negotiate the right to "tag-along" and participate *pro rata* in such a sale if they are not purchasing the equity interests themselves. Finally, restrictions on transfer to certain persons may be set forth, notably a competitor or the affiliate of a competitor, or if the equity interest descends to a family member, not allowing the family member board or management participation, to prevent a person without expertise or a commitment to the company from disrupting management, while allowing the pure economic interest to be inherited.

If the equity holders wish to provide for the situation in which one wants to be bought out by the others ("Buy-Sell" rights), the beginning of company life is the time to do it. Valuation procedures, giving of notice, time to respond, and how and in what time period the resulting transaction should occur should be provided for.

h. Registration Rights. Founders and investors/equity holders, particularly minority shareholders, may want not only "tag-along" rights, the right to participate, *pro rata*, in a sale of the company or a stake in it, but the right to register restricted stock in the event of a public offering or other registration of shares. These rights can include the conversion of preferred shares or equivalents to common stock, conversion of debt instruments, and unvested option rights.

i. Restrictive Covenants and Non-competes. Any provision to prevent a founder/investor from leaving the company and immediately going into competition against it, hiring away employees, using inadequately protected intellectual property, etc. should be set forth. Typically, courts will only enforce restrictive covenants limited in time, scope, and geography, but more latitude is often permitted against company founders, and when the restrictive covenant was a key part of a sale of the company consideration. Besides, without such protections, there are usually no protections against competition from departing founders/investors/employees at all.

j. Dividend Rights. Dividends are not usually an issue in early stage companies, but that's not always true. Rights to receive dividends or other distributions, when, and under what circumstances, should be established.

k. Accounting Rights. The rights of equity and debt holders to receive annual, quarterly, and other reports of profits and losses should be established.

l. Business Plan Approval. The right to approve an annual business plan should be established. The entire strategic direction of the company can depend on its business plan: what products to develop earliest, what hires to make, what alliances to seek, what financing is needed. If business plan approval is left in the hands of a simple majority of the Board, or even company officers, decisions taken ostensibly in accordance with the plan (or left silent by the plan) become very difficult to contest.

m. Indemnification, Insurance. Although generally not controversial, indemnification by the company of its officers and directors for their actions and insurance of them will not exist if not put in place, and, of course, will be more difficult to agree to once an indemnifiable or insurable event actually occurs.

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