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Professional Perspective

Founder-Friendly Control Rights for Startups

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In the wake of the WeWork debacle, much ink has been spilled about the poor corporate governance practices that led to the company's sharp decline in value ahead of its planned initial public offering. In short, WeWork's chief executive and founder Adam Neumann routinely caused the company to enter into transactions with related parties—including several high-dollar transactions with Neumann himself—often to the detriment of the company.

Neumann's ability to cause the company to engage in these self-serving transactions was made possible in part due to WeWork's multi-class voting structure, which granted Neumann's shares of stock much greater voting power than that given to other stockholders.

WeWork's share structure and governance practices contributed to its ultimate downfall, and can serve as a cautionary tale for practitioners as they advise their clients. Although a multi-class voting structure such as that adopted by WeWork may be appealing to founders seeking to protect their own interests, such structures can be detrimental to the company and may have a chilling effect on investment. Practitioners should instead advise companies to adopt a more standard approach to share structures and governance, particularly when representing early-stage startups.

Startup Share Structures

WeWork's proposed structure was extreme: its first public offering filings disclosed that Neumann's shares would receive 20 votes for every 1 vote granted to other shareholders. Similarly unbalanced voting structures are increasingly common in high-value tech startups. Indeed, Facebook, Uber, Lyft, Alphabet, Zynga, and several others have implemented dual or multi-class share structures, often in connection with taking the company public. Such arrangements have allowed founders to retain control of the company through multiple rounds of funding, even though they may not own a majority of the stock.

Startups typically raise capital by selling shares of stock to investors, resulting in the dilution of the other shareholders' ownership. Founders of early-stage startups are commonly concerned about protecting themselves against this dilution, desiring to retain control of the company and ensure that they are not later ousted from the C suite by the board of directors. Founders with concerns about dilution may wonder whether it makes sense to adopt supervoting share structures (such as that used by WeWork and others) when the company is formed, or whether there are other founder-friendly protections that can be implemented to ensure that the founders retain control during the early stages.

As noted above, a dual or multi-class share structure that grants supervoting shares to founders is often implemented by a company in connection with an IPO. With more private venture capital proceeds available, IPOs are occurring later and later in the company's lifecycle, after the CEO or founder has proven to be a "visionary."

Importance of Early Stages in a Startup

In the early stages of a startup, the company founders are often untested and are in the process of proving to investors that they can run the company effectively. While they may desire to implement a supervoting shares structure in connection with the company formation or during its first outside investment round, this choice can have a chilling effect on investment, and interested investors likely will require the company to change to a more typical share structure.

This can be challenging to explain to first-time founders, as they may not appreciate how important it is for a startup that will be raising venture capital to be organized in a customary manner. A standard set of incorporation documents can go a long way in giving prospective investors comfort that the startup has been organized properly by a knowledgeable practitioner who understands their industry. Venture capital investors performing due diligence on prospective portfolio investments expect to see a very standard corporate structure, and any material deviations from that structure may raise red flags for the investor.

Practitioners should provide this context to founders when discussing what share structures and voting rights to implement in connection with the organization of the company. Laying this groundwork early can set the company up for success as it tries to raise venture capital from investors at an early stage, a time when access to capital often presents the most challenges.

Avoiding Dilution

So, what can early-stage founders do to maintain control of their companies and protect themselves from dilution?

Obviously, one way to avoid dilution is to sidestep dilutive funding rounds altogether, either by self-funding the company or by seeking non-dilutive funding, such as Small Business Innovation Research grants. A company that is able to bootstrap in this manner until it achieves traction will eventually be able to raise money at a much higher valuation, resulting in less dilution to the founders. It also gives the founders more leverage when they do raise money because they have been able to achieve some success and are not as untested as an early-stage founder.

A company that attempts to bootstrap in this manner will try to stretch what cash it does have as far as possible, including with regard to legal spend. Practitioners advising such companies can provide helpful insight as to what legal matters need to be addressed immediately and which ones can be deferred until the company is in a later stage with more available capital. It is often more expensive to correct legal issues that arise after the fact than it is to address them prospectively, and helping founders navigate these decisions can allow them to use their cash in the most efficient manner.

Maintaining control of the board of directors for as long as possible can also help curtail dilution. In the early stages, the founders often serve on the board of directors, but over time this may change as the company closes on investment rounds and key investors insist on taking board seats. While this is often impossible to avoid entirely, founders may be able to satisfy investors who want a board seat by instead granting them information rights or rights to observe board meetings. If an investor does insist on taking a board seat, founders should be very selective about which individual will be representing the investor on the board. Founders should make sure the individual is a good fit with the company and that there is a high level of trust.

Founder Control Rights

In most cases, sophisticated investors understand that motivated founders who have appropriate "skin in the game" will perform better than those who have been heavily diluted. For this reason, founders who continue working for the company will often be granted stock options periodically to incentivize them to continue pushing the company forward. Since the board of directors of the company must approve all stock option grants, it is important to make sure that all directors understand the contributions of the founders to the growth of the company. If a founder is performing, she will typically be of great value to the company and rewarded accordingly. Over time, as the trust of investors and the board is earned, founders may be able to push for more generous option packages or share awards.

Practitioners should urge founders to consider their future capital needs and hiring needs at an early stage and be proactive in developing projections, including preparing pro forma capitalization tables illustrating the expected dilution in different scenarios. This can help illustrate the impact of dilution on the founders' shares and help ensure that the company is allocating an appropriate number of shares to its equity incentive plan to have available for stock option grants.

Finally, founders should be mindful about protecting their shares from dilution against one another. This is most commonly accomplished by having the founders vest their shares over time based on their continued service to the company. Founders often voice concerns about subjecting their own shares to a vesting requirement, particularly when this is suggested by their own legal counsel as a proactive measure rather than being imposed by an investor. Practitioners should explain that the vesting requirement protects the founders as much, if not more so, than the investors, since it helps avoid so-called "dead equity." That is, equity on a company's capitalization table that has been issued to a founder who is no longer working to advance the company.

There is nothing worse for a company than having a founder that owns a substantial percentage of the company's common stock depart the company and retain that equity ownership. Vesting provides a mechanism for the company to buy back the unvested shares of the departing founder, often at a nominal purchase price. Investors will often insist that key employees of the company vest their shares. However, even if it is not required by investors, founders would be well-served to impose a vesting requirement on each other to make sure all founders actually earn the equity they are granted.

In these ways, founders can protect themselves from unnecessary dilution and ensure that their voice continues to carry weight as the company grows.