



## Founders: The Control Quandary

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**Issue:** *The difficulty for most founders starts when they raise funds from financial investors like VCs and PEs. The extent of difficulty is the highest (for most start-ups) in the initial funding rounds. This is when the start-up is often financially vulnerable.*

The approach of VCs/PEs in India to the term sheet and documentation is mixed. Following trends in the US investment ecosystem, some VCs are getting comfortable with a 'light' term sheet and basic rights; however, a greater number insist on 'heavy' documentation and rights. PE investors - which come in a bit later- usually fall in the 'heavy' category.

In this note, we are limiting our comments to transactions involving 'heavy' documentation and rights. In such cases, legal documents become quite onerous for the start-up and founders. From the perspective of the founder, this is a disorienting situation. They are used to being in total control of what they have built. However, with their first fund raised from financial investors, life will totally change.

Typically the founder's shareholding will reduce quite materially from what it was – and will continue to drop with every fund raised until it often becomes a fraction of their initial shareholding (This is not always a bad thing so long as the drop is not distressed – because it does bring a host of beneficial commercial and financial implications along with it); their unchecked right to manage the start-up will seriously be controlled and limited. From being and feeling as the 'owner' of their start-up, they may now feel like senior employees bound by a very strict and lengthy employment contract; and this employment contract can be terminated, leaving them potentially with no role in the management of their own company.

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**Thoughts for founders:** This note looks at things from the perspective of the founders. Notwithstanding the above 'adverse' consequences to their interest imposed by the investor, the founder remains a shareholder. This is a very precious right. And it is surrounding this right (of being a shareholder) that a clever and able founder can negotiate - provided the condition of their start-up allows them to do so - sensible rights in their employment contract and their shareholder's agreement.

Needless to say, founders should vigilantly protect their rights, as best they can, from the very first set of formal documents they execute. The first set will be the base upon which subsequent investors will build – so things could mostly get tougher for the founder.

It is beyond the scope of this general note to comment on details but generally, the areas on which the founder should focus are:

1. Ownership/ dilution of stake and agreeing on equity-linked rights or upside sharing (since this is the primary pathway to his wealth) and tie them sensibly to timing, performance, milestones and sale;
2. Minimising the barriers to raising further capital. In this regard, it is also important for the founder to agree to fair anti-dilution protection (typically broad-based weighted average) to apply in case of a down round, instead of full ratchet anti-dilution protection;
3. The scope, roles and responsibilities of the founder as an employee, the events that may lead to termination of employment, the procedure for termination of employment not being one-sided, and the contours of their employment compensation (since this is the primary pathway to relevant income) and tie it progressively to timing, corporate performance and milestones;
4. Minimising the chains of control imposed on them under the employment contract and under the shareholder's agreement thus securing operational freedom. This can be progressively tied to a variety of factors including improved corporate performance;
5. Obligations in relation to providing exit to the investors and consequences of not providing such exit;
6. Securing sensible and fair shareholder rights for themselves during the employment and post-employment phases; and
7. Securing an adequate separation between their role as an employee and their rights as a relevant shareholder.

We are increasingly seeing founders becoming quite resistant to the demands of the investors. That is a good thing because it may eventually help to create standardisation in the market – at least in certain categories of investments - that will bring more efficiency with which deals close.