Financing Your Startup: Understanding Control and Voting Issues

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When negotiating a term sheet for an angel or venture capital investment, control over future company decisions is frequently a key tension point between founders and investors. There are many different ways for a founder to retain, or a new investor to obtain, control over a startup.

Control rights, which may relate to board of director and/or shareholder level actions, typically come in two forms:

- Blocking rights, which are the right to veto or stop an undesirable action; and
- Approval rights, which are the right to force a certain action to occur.

Below is a brief, but not exhaustive, outline of typical control rights found at the board and shareholder levels in early-stage financings.

Board of Director Controls: Controls with respect to board-level decisions can be implemented in two ways, with many startups utilizing both simultaneously.

The first method of allocating control at the board level is the ability or right to appoint directors to a company's board. This usually arises from one or more of the following:

- a voting agreement whereby the company's shareholders contractually agree to vote for the director(s) designated by a specified constituency (*e.g.*, the founders, holders of common stock, holders of a series of preferred stock, etc.);
- an express designation of a board representative elected by a specified class or series of stock set out in the company's articles of incorporation (the "Articles"); and/or
- restrictions added to the company's Articles or bylaws limiting the size of the board (*e.g.*, setting a maximum number of director seats).

The second method of allocating control at the board level is to provide certain parties with "blocking" rights by increasing the approval threshold required for various identified actions. For example, approval of certain actions might require the agreement by a particular constituency's board member, giving such director a veto in the event such director withholds their approval. Similarly, board approval can also be conditioned upon the agreement of a super-majority of the board members or even a requirement that the board vote must be unanimous. These increased director voting thresholds can be implemented by adding provisions to the company's Articles or bylaws, or through a contract among the shareholders such as an investor rights agreement.

Shareholder Controls: There are a number of mechanisms available to increase the control of one or more groups of shareholders, such as the founders or all holders of a certain series of stock (*e.g.*, Series A Preferred shareholders). These mechanisms, which many startups utilize in combination with each other, include the following:

- Separate shareholder class voting rights (*referred to as* "protective provisions") in the Articles requiring approval by the

holders of a particular class or series of stock for certain specified corporate actions, thereby giving those shareholders veto rights over such action being taken, even if approved by the board.

- A requirement for approval by a larger number of shareholders than the default required by law. This higher threshold, which is typically included in the Articles, can apply to some or all corporate actions requiring shareholder approval.
- The addition to the Articles of shareholder approval requirements for actions not ordinarily requiring a shareholder vote under the applicable corporate law.
- The grant of contractual rights to certain shareholders to purchase some or all of the stock sold by the company in the future. This is referred to as a preemptive right or right of first offer. It is often placed in the investor rights agreement.
- A prohibition on amending the Articles, bylaws and/or contracts among the shareholders unless the company obtains the approval of a certain percentage of shareholders and/or certain groupings of shareholders.
- A contractual requirement that all shareholders agree in advance to approve certain actions under specified conditions. The most common form of this type of provision is referred to as a "drag-along" clause. Pursuant to a drag-along provision, the shareholders agree in advance that if a certain number of grouping of shareholders approve an action, the other shareholders will vote in favor of such action as well.

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