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Should founders have a shareholders agreements?

When a startup is being organized, the company founders should consider whether to enter into a shareholders agreement. A shareholders agreement typically establishes certain rights and responsibilities of the founders and the board of directors and is separate and distinct from the agreement that founders sign to purchase their shares.

The rights and responsibilities usually addressed in a shareholders agreement may include the following:

Board composition

The board is the governing body of a corporation. In a typical startup, whoever controls the board controls the startup. So it is very important to address who is going to serve on the startup's initial board and, moving forward, what votes are required to change the board composition. If there is no agreement on this point, then a majority of the voting stock would usually be entitled to select the entire board.

Vesting of shares

The vast majority of venture investors require that all shares and options held by the founders (and other employees) of the startup be subject to vesting. The typical vesting schedule in Silicon Valley is four years, with 25 percent vesting upon the completion of one year's service and, thereafter, the remaining shares vesting in equal monthly amounts over the next three years. If a founder stops providing services to the startup, then the company can take back the unvested shares or options held by the founders. Without this vesting concept, founders could quit working on behalf of the startup and retain all of their shares. This can create a number of issues, including making fundraising very difficult. To avoid this, the founders should seriously consider imposing vesting on their shares, either in the Shareholders Agreement or in the stock purchase agreements entered into at the time the stock is issued to the founders. For more on founders stock vesting issues, please see our article.

Transfer of shares

Given the fact that startups are very closely held upon formation, there is a concern that only the founders own the initial shares and that there be limits on when the shares may be sold or otherwise transferred. It would be typical for the company and/or the other founders to have a right of first refusal on the transfer of shares the selling founder would need to let the company and/or other founders purchase the shares on the same terms and conditions offered by a third-party purchaser. The founders may also have co-sale rights to the extent that the right of first refusal is not exercised. A co-sale right allows the other founders to participate with the selling founder in selling a pro rata amount of their own shares to the third-party purchaser. In many instances, there is also a prohibition against transferring shares to a company competitor and selling unvested shares. It is also typical to address what happens to the shares if a founder divorces the other founders probably do not want the divorcing founder's spouse to be a shareholder in their startup. If these rights and restrictions are not set out in an agreement or the company's Certificate of Incorporation or bylaws (the organizational documents), they will not exist, and there would be only minimal restrictions on the transfer of the founders' shares. As in the case of vesting, some of these terms may also appear in the founder stock purchase agreements.

Special voting rights protective provisions

While most company business matters are determined by the board or company senior executives, shareholders may retain by agreement the right to approve certain matters before they may move forward. These matters may include (i) the incurrence of debt over a certain amount; (ii) the issuance of equity securities that are senior to the common stock with respect to preferences and privileges; (iii) the sale of the company; (iv) a material change in the nature of the company's business; and (v) increases in founder compensation. These matters are usually of critical importance to the founders, so they may even require a supermajority (instead of just a simple majority) vote before they could be undertaken.

Often, founders do not want to address such critical issues at the time a startup is being organized, due to time and money constraints. Instead, they are willing to let existing law and their organizational documents control these issues. The problem with this approach is that the law and the company's organizational documents may not cover all these issues, or may not address them in a way that is satisfactory to the founders. The founders should come to an agreement on these concerns early on; then, should an issue arise, there is a clear way of dealing with it. While the company's organizational documents and founder stock purchase agreements may address some of these issues, founders should carefully consider whether an additional shareholders agreement should be used to address issues not already covered in those other documents.
