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Navigating Control Mechanisms in Startups

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The question of control is pivotal for startups and their investors. Startup founders naturally desire influence over their company's direction, but when external investors enter the picture, the dynamics of control often change.

Before raising capital from outside investors, founders typically maintain control over the direction and day-to-day activities of the company. When third party investors arrive, however, a key point of negotiation is the extent to which the founders accede control to the investors. It is almost inevitable that the desires and interests of founders/management and investors will diverge. This article reviews the mechanisms that founders most frequently utilize in order to maintain control, as well as the tools that investors employ to counterbalance that power.

Dual-Class Stock

One of the most powerful, and controversial, tools for founders is the institution of dual-class stock with a super-voting mechanism. Dual-class stock structures can give founders voting rights in excess of their economic ownership in the company. A dual-class structure bifurcates the company's common stock into two sub-series: (i) a super-voting series held only by one or more founders (and, in certain instances, other early stockholders), which carries multiple votes per share (the specific multiple can vary significantly), and (ii) a series of common stock carrying one vote per share. The primary effect of a dual-class structure is to give founders voting control over any matters that would require a majority vote of the company's outstanding capital stock (which, for a Delaware corporation, would include a merger or a sale of substantially all of the company's assets). Generally speaking, the preferred stock purchased by investors would convert into the series of common stock carrying one vote per share.

Venture capital investors are resistant to dual-class structures, and tend to accept them only when the founders are serial entrepreneurs with a track record of successful exits or IPOs or where there is supersized demand for a certain investment. Investors will want to understand the scenarios in which the founder anticipates relying upon their outsized voting rights, and will assess whether they are comfortable with how the founder might vote in such scenarios. In certain instances, investors will oppose a dual-class structure in a company's earlier preferred stock financing rounds, but may become more supportive once the company has established a strong growth trajectory and nears an IPO. In many cases when a dual-class structure is implemented, it is done so immediately prior to a company's IPO, so as to preserve management and early stockholder control over the business once its stock becomes publicly traded and more susceptible to shareholder activism.

Investors who are open to accommodating dual-class structures will often seek to impose guardrails on such structures. The most common guardrail is termination of the super-vote upon the occurrence of trigger events, e.g. (i) the founder ceasing to serve in their current role, (ii) the founder transferring their shares to an entity that they do not fully control, or to a third party outside the designated founder group, (iii) the passage of time without the company achieving a liquidity event or (iv) immediately prior to the consummation of an IPO (less than one-third of U.S. listings in 2023 had multi-class stock).

Board Control

Control of the company's board of directors can also be a hotly contested issue. Founders can retain voting control over major decisions in the corporate lifecycle by comprising, or holding the right to designate, a majority of the members of the board. This control is always somewhat tempered by the fact that a director of a Delaware corporation is subject to fiduciary duties when acting in his or her capacity as a director, which include the duty of care and the duty of loyalty (which requires acting in the best interests of the company and its stockholders). This requires all directors, including founder and investor directors, to utilize their board position to serve the interests of the company and its stockholders (rather than any narrower constituency, e.g., the founding team or the preferred stockholders).

The size of the board will typically grow over time to accommodate the appointment of investor designees, industry experts and other independent directors. Once the founding team ceases to comprise a numeric majority of the board, there are numerous tools that founders utilize to provide themselves and their designees with continued control over board votes. For example, founders may agree to add board seats for investors or independents, but negotiate for the right to vote any vacant seats on the board or to hold a tie-breaking vote in the case of a deadlock. Another strategy is to give founders more than one vote per seat to either give them an outright block or more power to swing a vote. Founders also sometimes seek negative consent rights, whereby the vote of one of the founder directors is required to undertake certain actions, such as an exit event or firing a member of the founder group. Such negative consent rights could also be implemented at the stockholder level, where the consent of holders of some numeric threshold (e.g., a majority) of the founder shares or common stock would be required to undertake such actions.

Boards of more mature emerging growth companies often include one or more seats for so-called "independent directors", who are typically industry experts. On "balanced" boards with an even number of founder and investor designees, the independent director(s) can hold a tie-breaking vote. From both the founder and investor perspective, it is critical to carefully diligence any proposed independent directors and to understand the constituencies with which they are more likely to align. Additionally, all parties should carefully review the proposed rules governing the removal of directors and the designation of replacements. For example, the founding team might be comfortable with the initial independent director, but if the preferred stockholders have designation and removal rights as to the independent seat, they could replace that director with one who is less aligned with the views of management.

Founders and investors should also familiarize themselves with any terms of the company's bylaws or voting agreements that would provide for removal of directors for cause (and should carefully review the definition of "cause"). Under Delaware law, directors can be removed by the stockholders for "cause" even absent any such provision in the bylaws or voting agreement. Under Delaware case law, grounds for a finding of cause have included intentional breach of fiduciary duty and other bad acts (including fraud, misappropriation of company funds, failure to adequately disclose conflicts, and so forth).

Investor Protections

The investor perspective on founder protections is nuanced and context-sensitive. When considering the founder-protective structures summarized above, investors are typically concerned about (i) preserving the ability to replace an ineffective management team, if needed, (ii) imposing basic safeguards to ensure that founders run the business in a disciplined and accountable manner, (iii) preventing founders from blocking major corporate lifecycle events (e.g., vetoing a sale in the hopes of securing a higher-dollar value exit in the future), and (iv) limiting "dead-hand" control (whereby a founder retains an outsized degree of control after leaving the company). As noted above, investors will often be more inclined to grant additional control to an experienced founding team that the investors believe will successfully scale the business. Founding teams will also have more bargaining leverage to seek protective terms in a founder-favorable market cycle or if the company operates in a thriving market segment.

In the first instance, investors can limit founder control by rejecting or softening the founder-protective structures summarized above. In addition, investors can negotiate negative consent rights to prevent mismanagement (e.g., budget approval rights) and to guard against major transactions (e.g., M&A and future financings) being undertaken without their consent. Investors can also utilize the drag-along right set forth in the National Venture Capital Association form of voting agreement to prevent a holdout founder from scuttling a proposed sale of the company (presuming that such holdout founder is unable to block the sale by other means, e.g., by way of a board or stockholder level veto), which would require such a founder to vote their shares in favor of the proposed sale. Further, investors can seek to limit dead-hand control by tying founders' board designation rights—and any founder block on exercise of the drag-along mechanism—to the founders' continued provision of services to the company. Investors can also minimize dead-hand control by subjecting founder shares to vesting (or, in the event that a founder has vested in full, re-vesting), the effect of which is that a founder who leaves the company before vesting in full will have fewer shares to vote.

Conclusion

The protective mechanisms summarized above are not "off-the-rack" solutions to be deployed irrespective of context. Rather, founders should thoughtfully select mechanisms that are appropriate in light of transaction dynamics. In addition, none of the tools discussed above should be viewed in isolation. Rather, parties are advised to analyze the full set of founder and investor controls, at both the board and stockholder level, in tandem with the company's capitalization table. This holistic analysis allows founders and prospective investors to understand the practical impact of dual-class voting structures, board controls, and negative consent rights in the specific scenarios in which they are most likely to be relevant (including, among other things, future capital raise events, liquidity events, and the termination of members of the management team). We also note that most venture-backed startups feature an overall balance of control as between founders and outside investors, with more exotic protective structures (such as super-voting) being the exception rather than the rule.

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