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Venture Capital Shareholder Agreements—More Attention Now, Less Heartache Later

By Daniel T. Janis

The Shareholder Agreement—Overlooked, Underestimated

It's an exciting time for a client when a venture capital investor (VC) comes onto the scene. Company founders work hard to find financing. When big money and an attractive valuation are proposed, it's hard for them not to get caught up in the moment. But financing always comes with strings attached. Clients need to be aware. Show me the money! (But give me a reasonable shareholder agreement too.)

"Investor Rights Agreement," "Right of First Refusal and Co-Sale Agreement," the simple "Side Letter" are all different varieties of shareholder agreements. Whatever the shape and size, a shareholder agreement can contain a broad variety of potential tricks and traps.

Term sheets for VC investments usually outline all of the major terms that will be contained in the investment documents, including the shareholder agreement. In a perfect world, where clients consult their attorneys before making big decisions (and listen to the offered advice, and send holiday candies…), lawyers get a copy of the term sheet in advance and have a chance to walk their clients through all of the provisions and implications. In the real world, clients often review the $X investment amount on line one, the $Y valuation amount on line two, and the signature block on page ten, and then send the executed copy to their lawyer. Condition your client in advance! When you catch the slightest whiff of a financing in the air, be relentless in making the point: no signature on the term sheet until we understand the shareholder agreement!

The ultimate purpose of a shareholder agreement is to provide a VC with rights above and beyond what it would have simply by virtue of its overall percentage ownership of the company. The main issues addressed in a shareholder agreement are: (1) ownership (restrictions on share transfers); (2) conduct of business (board composition and consent rights); and (3) exit (drag-along rights).

Steering Clear of "That Guy"

VCs want to know who they are getting in bed with (who wouldn't!) and be sure that company ownership cannot substantially change without their consent. Founders and other key shareholders almost always have to accept some restrictions on transfer. The questions are, how tight are the restrictions and to whom do they apply?

Carve-outs permitting transfers to trusts and estate-planning vehicles are common and, if important to a founder, should be demanded. Who should be restricted is complicated, and sometimes contentious. Restrictions can take the form of outright prohibitions on transfer, right of first offer/right of first refusal provisions that permit transfers, but only after the VCs or other shareholders are first given the right to buy the shares, or both. There is an inherent tension between, on the one hand, founders and the company (who collectively want tight control in anticipation of a financing) and, on the other hand, common shareholders who are not founders, but may hold some substantial portion of shares (who often feel like they should not be subject to transfer restrictions). Not anticipating these dynamics in advance of a financing can result in giving inadvertent leverage to individual shareholders at the very moment when having a united front is most important. Internal shareholder relations are in the same category as corporate housekeeping matters and general skeletons in the closet—things that need to be tidied up and addressed proactively in advance, not ignored until VCs start asking their inevitable due diligence questions.

Hey Man, We're Trying to Run a Business Here!

VCs always require some level of control over the company, even when they hold less than a majority of shares. Control comes

in the form of the right to appoint board members and the right to veto certain specified actions. The balance to be struck in the shareholder agreement is for the VC to have enough control to protect its investment while not stifling the company's agility in an ever-changing business environment. When founders and VCs see eye-to-eye (typically at the moment of funding), everything is great. But when visions start to diverge (usually when business is not growing as planned) the specific wording in the dusty, long-forgotten shareholder agreement becomes front and center. Founders should negotiate these provisions with the worst case scenario in mind, and be confident that they could effectively run the business if the VC exercised every veto right possible, and the VC director opposed every suggested initiative.

Running for the Exits

Drag-along rights allow a VC to force other shareholders to sell their stock when the VC finds a buyer. The critical component of a drag-along right is the threshold price above which a shareholder must sell. While the interests of shareholders of all classes are usually aligned when the sale price is high, interests start to diverge when the sale price is lower (when it becomes more likely that, after paying the preference on the VC's preferred shares, little or nothing will be left over for the common shareholders). Here again, founders need to assume a gloomy scenario when agreeing to terms. Nobody reads a shareholder agreement during a blockbuster sale. But they revisit every page when the deal is not so good.

Pay Attention; Read the Shareholder Agreement

There is more to a VC investment than money and valuation! Shareholder agreements give VCs extensive rights, far beyond the economics reflected in a company's charter. Lawyers should, in their usual buzzkill lawyerly way, force their clients to slow down and think about how restrictive shareholder agreement covenants will feel during the lean times, even when the lush times (the funding wire transfer!) are close at hand. Reading the fine print, and understanding the nuances and dynamics, is critical. Recite these mantras until your clients know them cold: don't sign a term sheet without counsel; read the shareholder agreement slowly; read it to the end; read it again. Negotiate a solid shareholder agreement on behalf of your client. If everything goes well, you'll never read it again. And if not, you'll be glad you did.

Daniel T. Janis is a corporate attorney at Davis, Malm & D'Agostine, P.C. in Boston, specializing in mergers and acquisitions, corporate finance and representation of public and private companies in a range of general and transactional matters. When not deconstructing shareholder agreements, he is playing bass and attempting to run a marathon in every state.