EXPLAINING AND ANALYSING THE SOURCES OF FOUNDER-INVESTOR CONFLICTS, A PERSPECTIVE THROUGH THE LENS OF THE COMPANIES ACT, 2013

Armaan Goyal, Jindal Global Law School

ABSTRACT

The scope of this research paper extends to discussing and analysing investor-founder conflicts within the sphere of the Companies Act, 2013(the Act). This is in order to streamline the paper considering the numerous investor-founder conflicts under other facets of law.

The paper will work to elucidate upon specific areas of contention between founders and investors in order to better understand the complex relationship of two crucial stakeholders in a company.

Therein, the research methodology is to meld the incidence of statutory provisions, stakeholder objectives, stakeholder leverage and jurisprudence to clearly elucidate most relevant investor-founder conflicts.

The topic at hand is worthy of investigation and of modern relevance considering the tremendous volumes of new startups (considering the governmental policies of 'Startup India, Stand up India'). Whilst, on the other hand the investment market is uncertain due to COVID-19. Thereby, conflicts are more likely to arise, with the negotiating power of the investors substantially increasing.

Introduction:

Prior to delving into understanding founder-investor conflicts we first must understand what a founder and investor mean. Firstly, this paper does not equate the concept of *'promoter'*[1] and a founder; but concedes that all founders are promoters as they fit into the definition promoter as per §2(69)(b and c) of the Act. Investors, for the purposes of this essay, shall be defined to be anyone who through equity financing has secured shares in the company. In this manner, this essay excludes debt-financiers, debenture-holders etc. This is because the true crux of investor-founder conflict only arises once both parties have differing aims and try to exert control over the company in a contradictory manner.

Founders, especially those involved with startups, are quite often desperate to secure finance, either to scale or for maintaining working capital. This fiance often is raised through equity financing. There are three major types of equity financing: venture capital, angel investments and listing the company's share on the securities market.

However, raising finance through venture capital works to create the majority of investor-founder conflict. This proves to be the case as venture capitalists(VCs) invest their money usually in return for equity or *shares*[2] in a company, but also negotiate to secure other numerous rights to safeguard their investment.

Control and Founder-Investor conflicts:

The foremost founder-investor conflict is regarding the operational and legal control over the business.

Firstly, the goals of the founder and investor are not always harmonious, this can be said as an investor has a singular aim of profits, in the form of increased share valuation or dividends. Whilst the founder would be concerned with achieving his vision for the company, even at the cost of present profits/valuation. This rift in goals combined with investors having certain rights causes the conflict of control. Equity shareholders of the company, as per the Company Act, are entitled to affect the working of the company by appointing directors to the board of directors to represent their interests[3], initiate winding up of the company,[4] deciding

[1] The Companies Act 2013, §2(69)
[2] The Companies Act 2013, §2(84)
[3] The Companies Act 2013, §151-152
[4] The Companies Act 2013, §226

on investing and borrowing beyond certain limits etc.[5] The existence of such provisions necessitate the founder taking approval of the shareholders before making decisions on certain subjects as per the Act. This in turn dilutes the operational control the founder exerts.

In fact, generally most VCs in India ask for a seat on the Board of Directors to ensure their interests are protected.[6] Furthermore, most VCs negotiate for further *affirmative rights* such as exit rights, pre-emptive rights, participation rights, and voting rights etc. Affirmative rights in general mean a protective rights or veto rights granted to investors on certain matters pertaining to the company. Granting such rights increases the operational control of investors and protects their interests, but does not affect the legal control/ownership stake of the company. The Securities and Exchange Board of India(SEBI) Appellate Tribunal in the case of *Shubkam Ventures v. SEBI*[7] holds that affirmative rights are enforceable and also that providing affirmative rights to financial investors does not essentially mean that such an investor is being vested with the "*control"*[8] over the company. Such provisions and rights accruing to investors are usually specified as a part of the term sheet between investors and companies, and solidified as a part of the shareholders agreement.[9] These affirmative rights are discussed later as sources of investor-founder conflict.

The conflict regarding control is captured exceptionally well by Noam Wasserman's concept of The Founder's Dilemma.[10] The concept is elucidated via the diagram below:

[5] Pandey RK, Shroff SS and Nijhawan V, "Shareholder Rights and Powers in India" (*Lexology* July 10, 2018) <https://www.lexology.com/library/detail.aspx?g=c644e5fb-de6e-461c-886e-56aba0902939>

[6] Mallik N, "Protection of Founder Interests in Venture Capital Transactions" (*Vantage Asia*June 29, 2020) <https://www.vantageasia.com/protection-founder-interests-vc-transactions/> accessed October 6, 2020

[7] Civil Appeal No. 3371 of 2010.

[8] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 2011 (Takeover Regulations)

[9] Desai N, "Startups and Venture Capital Investments" (*nishithdesai.com*September 2018) <http://www.nishithdesai.com/fileadmin/user_upload/pdfs/Research_Papers/Startups-and-Venture-Capital-Investments.pdf>

[10] Wasserman N, "The Founder's Dilemma" (*Harvard Business Review*August 11, 2014) <https://hbr.org/2008/02/the-founders-dilemma>

As can be seen, the concept contends that the general trend is that the more equity financing one does, the more likely his/her company is to succeed. Whilst at the same time, the more equity one gives the less control he/she has on their company. Thus, Noam contends founders are presented with a choice, be kings of your company and remain a small company, or scale and become rich at the cost of losing control. He backs his arguments by stating that within three years of securing venture capital 50% of founders were no longer the CEO; by the fourth year only 40% were still in charge, and fewer than 25% headed the initial public offering.[11] Lululemon Athletica, American Apparel, and Best Buy are all examples of companies who forced their own founder out of the company.

In India, the board of directors is empowered to hire and fire executive officers of a company. Therefore, founders can be forced out by the directors. Yet, if the founders retain over 50.1% of the share capital they can still maintain legal control of the board of directors by way of structuring the board of directors to suit his/her personal needs. This means ensuring the board is stacked with those loyal to the founder. Essentially, a founder must be wary of his/her share dilution when raising equity financing as it would lead to both loss of operational and legal control.

Finance and Concerns of Founders:

Other than issues of control, investors and founders conflict on financial aspects. This issue is one associated with the concept of *preference shares.* Preference share capital is defined under §43 of the Act.[12] In layman's terms, it states that preference shares are shares of a company's stock with dividends that are paid out to shareholders before common stock dividends are issued. Further, in case of winding up of a company preferred shareholders are entitled to be paid before common shareholders.

This share goes hand in hand with investors generally asserting their *liquidation preference* and *participation rights.* Liquidation preference is a clause that states the initial payout that investors are guaranteed as a payout in time of a sale, winding up etc.[13] To illustrate: with a liquidation preference of 2x, your company sells for Rs. 10000 and the initial investment of the VCs was Rs. 3000. Rs. 6000 would go to the VCs before anyone else received any sum

[11] Ibid.

[12] The Companies Act 2013, §43

[13] Graham A, "Term Sheet Templates - Clauses to Look Out For During Negotiation" (*Toptal Finance Blog* February 20, 2017) <https://www.toptal.com/finance/fundraising/common-term-sheet-mistakes-founders-make>

of money. In this context, A 3x liquidation preference would earn Rs. 9000, and so on. Furthermore, if participating preference shares are negotiated for by the investor, there is potential for further upside after their liquidation rights have been fulfilled. In this manner if the investor is *fully-participating,* which is the most investor-friendly choice, it allows the investor to reclaim their original investment back via the liquidation rights and furthermore share in the remaining sum of money on a *pro rata* basis. This has been termed as 'double-dipping.'[14] This allows for investors to often receive greater proceeds from an exit, in comparison to their actual ownership stake in the company. Conversely, the most founder-friendly is *non-participating,* wherein an investor must decide between liquidation preference payout or a pro-rata share of the sum of money, rather than receive both. As one can see, the negotiation of these rights can prove to be very critical from a financial standpoint, and hence is an immense area of contention in the preliminary stages of securing investment from a VC.

Preference shares are issued to gain funds without giving up control as preferred shares, as per §47, do not have voting rights. Yet, affirmative rights encroach upon the operational control of the founder as is. Thus, the question arises: why do founders continue to give such robust rights and protections to investors? The answer is simple: many are faced with no choice as they fear potential investors backing-off, and they do not possess significant leverage to negotiate terms. This is especially true of startups, who are in infant stages of development. Founders must internalise that before committing to a transaction they should consider what leverage they have in an investor negotiation to enhance their post-funding position.

In order to better the position of such startup founders the government has launched the initiative "Startup India, Stand up India" which has amended various legislations to give a boost to the startup culture in India. Firstly, it has categorically defined a "Startup"[15] and arranged for incentives by the Reserve Bank of India, tax incentives and enhanced the ease of doing business.[16] Notably, foreign venture capital investors are allowed to invest in any startup regardless of the sector it operates in. This was much needed considering the lack of venture debt available in India.[17] As can be seen, the government is working to recognize sources of investor-founder conflicts and amending the same to create harmony.

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[14] Ibid.

[15] "Definition of Startup for Government Schemes" (*Vikaspedia*) <https://vikaspedia.in/social-welfare/entrepreneurship/startup-india-1/startup-and-government-schemes>

[16] Ibid.

[17] *Supra* note 9

Transference of Shares and Pre-emptive rights:

To safeguard their interests in a company both founders and investors place restrictions on the transfer of shares. For VCs, as per the VCF and FVCI Regulations, the equity subscription in a listed company must be for a minimum period of one year.[18] This is known as a 'lock-in period.' Moreover, founders also bar investors from ever selling shares to specific competitors of the company as well. Founders are also subject to a contractual lock-in period on transferring or diluting their shares. This ensures their commitment to the company and ensures the founder, a crucial stakeholder, does not sell his share to some third party.

Additionally, investors may ask for pre-emptive rights, or in layman's terms: *right of first refusal, call option, put option, tag-along rights, and drag-along rights.*[19] For the purposes of this paper only two such rights shall be discussed. The right of first refusal requires that the founders transfer their shares to third-parties only once it has been refused to be taken up by the other shareholders of the company. Drag-along rights are exit rights and allow the holder of such rights to force the sale of a company even when the majority of shareholders may not be in favor of such a sale.

Essentially, these pre-emptive rights serve as an impediment to transfer of share and demand that such shares be transferred to the agreed party(ies)/shareholder(s). These rights have caused significant conflict between founders and investors, specifically over the fact that such rights violate §58(2), the principle of shares having to be "freely transferable"[20] in listed companies. However, the proviso to §58(2) clarifies that agreements between shareholders regarding restricting transfer of shares shall be enforceable. This goes hand in hand with §6 (to override memorandum, articles, etc.) and §10 (effect of memorandum and articles) of the Act to uphold the validity of pre-emptive rights and restrictions on transfer of shares. This is clarified by the decision of *Messer Holdings Limited vs Shyam Madanmohan Ruia & Others,*[21] which upheld the pre-emptive right of refusal and asserted an agreement to place restrictions *inter se* shareholders to be enforceable. The same principle was also outlined in the case of *Bajaj Auto Limited v Western Maharashtra Development Corporation Ltd.*[22] Negotiations over

[18] "VCFs: Lock-in Period for IPOs" (*The Financial Express*July 9, 2006) <https://www.financialexpress.com/archive/vcfs-lock-in-period-for-ipos/170290/>
[19] *Supra* note 9
[20] The Companies Act 2013, §58(2)
[21] (2016) 11 SCC 484
[22] (2015) CDJ2015 BHC 1305

pre-emptive rights and their validity have continued to cause investor-founder conflicts. However, now that pre-emptive rights are settled law, a reduction in investor-founder conflict regarding these rights is to be seen.

Founder's Shares and Vesting programs:

Investors want to ensure that their investment is protected. For this reason, certain precautions are taken to protect investors against the downside of founders exiting or being ousted. In relation, vesting structures are put into place which decide how shares are vest onto founders. These are per the 'employee stock option' program(ESOP), via §2(37)[23] read alongside §62(1)(b)[24] of the Act. Furthermore, Rule 12 of the Companies (Share Capital and Debentures) Rules, 2014 lays out that on complying certain conditions only private companies can vest shares onto its founders under the ESOP. The two types of vesting allowed include time-based and milestone vesting. Time-based vesting links the vesting of ownership interest(shares) to time, an objective criteria. On the other hand, milestone vesting links the vesting of ownership to the occurrence of specific events, which is comparatively subjective criteria, as defining specific milestones is of relative subjective character.

From the founders' perspective what matters more than the vesting structure is the basis upon which their shareholding accelerates in the event they are fired or ousted by the company. In situations where a founder is terminated without cause, or forced out, there should be compensation to the founder.[25] The aforementioned will also work to deter the board of directors from terminating founders or key personnel for the purposes of the company buying-back equity. Full acceleration is often considered a reasonable request. After all, the founders are likely to have made drastic contributions to the company which cannot be ignored. However, VCs and other shareholders who do not benefit from such an acceleration are likely to oppose acceleration. In fact, such an acceleration would reduce their share of the consideration received in case of a sale.[26] This goes to show how vesting of shares and ESOPs prove to be an area of contention between investors.

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[23] The Companies Act 2013, §2(37)

[24] The Companies Act 2013, §62(1)(b)

[25] Gworek J, "Protecting the Legal Interests of Founders in a Startup Emerging Technology Company - JDG" (*Founder's Stock: Protecting Founders in a Startup Emerging Technology Company* August 2005) <https://www.morse.law/news/protecting-legal-interests>

[26] Doida Law Group, "Time Vesting vs. Milestone Vesting" (*Doida Law Group* September 11, 2017) <https://www.doidalaw.com/time-vesting-vs-milestone-vesting/>

Mismanagement, Fraud and Company Law:

The Act was formed in the aftermath of 'Indian Enron' and the Satyam fiasco thereby showing the weaknesses in India's investor protection schemes. This led to significant focus of the Act on establishing adequate investor protection measures.

In this regard, there have been a plethora of new investor-founder conflicts regarding such novel provisions. These include but are not limited to, §129 (Penalty for every director as officer-in-default for non-compliance with accounting standards and the procedure for preparation of financial statements), §166 (highlights duties of directors requiring them to act with good faith or else entails fine).[27] While most specifically directors can now incur criminal liability, and fraud has been introduced and given a wide interpretation.[28] These concern the founder as they are usually both a director and promoter in the company, and hence can be directly sued based on the aforementioned.

In fact, the case of the *Development Authority v. Skipper Construction Company*[29] held that the corporate veil of the company can be lifted in cases of criminal acts of fraud by officers of a company, "so as to enable it to pass appropriate orders to do justice between the parties concerned." This is reiterated in the case of *Shri Ambica Mills,*[30] and also in *Sunil Bharti Mittal v. CBI,*[31] wherein the apex court held that an individual can be held liable for an offence by the company. Hence, via these provisions the investor can directly initiate proceedings against a founder and therefore more effectively safeguard their rights.

Essentially, certain provisions allow for investors to directly sue founders in specific circumstances, thereby penetrating the corporate veil, and allowing for perhaps the most direct form of investor-founder conflict.

Conclusion:

The aim of this paper was not to try and resolve investor-founder conflicts, but rather indulge in a discussion of the same so that the paper understands these conflicts from both

[27] The Companies Act 2013, §129, §166

[28] The Companies Act 2013, §447; fraud means any act, omission, concealment of fact, or abuse of position by a person, with deceitful intent, to gain undue advantage from, or to injure the company's interest, or interests of its shareholders, creditors or any other person

[29] (2003) 3 ALT 9 (SC)

[30] (1974) SCC (4) 656

[31] (2015), 4 SCC 609

perspectives. Hence, via this paper one can gauge the pitfalls one faces as a founder and as an investor when dealing with one another. Hence, this paper is relevant to both founders and investors as a guide on protecting themselves from the other party.

However, this paper also brings us to the realization that investors are granted more safeguards under the Act, which often proves to be a site of conflict. This can be said as investors are allowed to utilize safeguards such as preferred shares, participation rights, pre-emptive rights and exit rights to protect their interests. Whilst on the other hand, the paper contends that founders must necessarily protect themselves against the investor by either structuring the board according to their agenda, exerting significant leverage while negotiating and indulging in acceleration of their stock upon termination without a cause.

After understanding investor-founder conflicts as per the Act one would be inclined to reiterate that both sides must make certain concessions to one another. This is in order to reach a harmonious end-result, which would likely be more conducive to the growth of the company and of profits, compared to constant in-fighting amongst crucial stakeholders.