Fundraising 101: Governance rights - What does a founder need to know?

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1. What are governance rights and why are these important to an investor?

As an early-stage founder, you are likely in control of your business. Having taken the business from idea to reality, you will be the one setting strategies and making key day-to-day decisions. It is also likely you want to be the person that continues to drive the business forward and deliver on the vision you have created for it. To help achieve that vision, you may need (more) investment and capital, which often means bringing on board external investors as shareholders.

Having such new shareholders will impact many aspects of your business, including its management and governance. New shareholders also bring with them fresh perspectives and expertise. Venture capital investors are not merely sources of capital; they can be useful partners in a startup's journey.

In return for parting with their cash, investors will expect oversight and some degree of control and influence over your company's material strategic decisions, finances and operations. The motivations for, and the extent of, this control may vary. Investors want to help shape the direction of the company and work with you to create value. At the same time, investors want to keep an eye on things and protect their investment, and more importantly for the company, to ensure that their investment contributes to building sustainable value to achieve the company's long-term goals. In reality, a combination of all these elements is usually at play.

This is where "governance rights" come in. "Governance rights" is a term used to define the various ways by which investors participate in and monitor the management and performance of a company, and getting the governance arrangements agreed in the transaction documents for your funding round will be a key part of any negotiation with potential investors. In negotiating what these "governance rights" are, the key goal for both you as the founder and the investor would be to find the crucial balance between protecting the business against risks with flexibility, ultimately supporting the growth of the business and the realisation of its vision.

The key governance rights that a founder likely needs to negotiate with investors are:

- **Director appointment rights:** these are rights to appoint and remove directors of the company. The business of a company is managed by its board of directors who, generally speaking, may exercise all the powers of the company. Accordingly, investors will often seek the right to nominate one or more representatives to the board as a means of participating in corporate decision-making, even if they cannot control the board. This involvement can be important not only for oversight, but also for bringing valuable industry experience and networks that can influence a company's strategic outcomes.

- **Observer appointment rights:** these are rights to appoint and remove observers to the board of directors of the company. A board observer typically has the right to receive the same information as a director, and to attend and sometimes speak at board meetings, with the key difference being that a board observer does not have any voting rights. Many investors seek to have board observer appointment rights in addition to (or at least as an alternative to) director appointment rights. Investors may not be able to directly influence board decisions, but oftentimes, board observers could add value to the board by encouraging transparency and fostering trust between board members.

- **Reserved matter / consent rights:** reserved matters are a list of specific matters, actions or decisions which require the approval of one or more persons. Investors often require stronger control over this list of matters, particularly at critical growth stages or in scenarios where the financial risk is higher. Approval of these reserved matters may be structured as being required either at the board level (i.e., needing the positive vote from one or more investors' appointed directors) or at the shareholder level (i.e., by way of positive vote from the relevant shareholders). There are often distinct lists which set out what items need either board or shareholder approval. Reserved matters can serve as an important form of negative protection and control for an investor. This is because the approval structure adopted

for reserved matters may allow an investor to block or veto such a matter, even if the investor is in the minority or outvoted at the board or shareholder level.

- **Information and access rights**: these are rights to receive regular and timely financial and operational reports (such as monthly or quarterly management accounts, annual accounts, reports on certain KPIs that track the performance of the business, etc.), as well as access to the company's books and records. These information and access rights help the investor perform its own due diligence and evaluate the company's performance, strategy and compliance, and are often also needed for the investor to fulfil its own management and regulatory reporting requirements.

2. What can a founder do in relation to governance rights?

To a founder, it may seem like the more rights given to investors with respect to governance and control, the less autonomy the founder has over the management of the company. If the balance between founder and investor control is not right, it can potentially hinder the efficient and expeditious running of the business. Accordingly, as a founder, you should seek to understand the expectations of investors as well as the perspectives and protections that investors can bring to the table to be able to negotiate carefully and strategically.

Some key factors founders should consider when thinking about the governance rights they are prepared to give investors are:

- **The stage of your company:** at the early stage, founders are typically best placed to run the business and therefore should be able to retain control of the board of directors – consequently, day-to-day operational matters should largely remain in the control of the founders. In addition, a company at this early stage may benefit from less stringent investor control, allowing founders to pivot and innovate more quickly. The early stage is, however, also the riskiest time in the eyes of an investor. So some investors may look for increased control over the key matters that may impact financial performance. Whilst investors will likely want to have a director representative on the board, they are more likely to seek influence through reserved matters (either at the board and/or shareholder level) primarily in relation to structural / ownership matters. At the later stages, it will become increasingly hard for founders to retain the ability to operate the business independently, and investors typically expect proportionate representation on the board with stronger reserved matter control rights over operational matters impacting on value. Such stronger control is often justified by the benefit that these investors bring in providing valuable guidance and resources that can help the company grow.

- **The type of investor:** different types of investors may have different expectations for governance rights, depending on their risk appetite, value proposition, and level of involvement. An investor primarily motivated by a financial return (such as a venture or growth capital investor) may be more focussed on information access and rights to monitor the company's performance, while a strategic or corporate investor may want to have more involvement in, and operational controls over, the strategic decisions of the company. Some investors view the making of operational decisions an important factor in driving success for the company and so would seek a balance between the two. Confidentiality and conflicts of interests are also factors to consider when dealing with strategic investors.

- **Amount of funding:** The amount of funding may affect the bargaining power and leverage of the parties. If there are multiple investors participating in a round, the lead investor putting in the most funds would typically expect a board seat, with co-investors either relying on the lead investor to represent the interests of the group or depending on contribution, requesting an observer seat. Later-stage investors, with larger investment amounts, may also typically expect stronger governance rights than those given to early-stage investors who only parted with smaller amounts of cash.

- **Future funding rounds:** Governance rights may also evolve with future funding rounds. Initial agreements on governance rights should be flexible enough to accommodate new investors who may have different expectations and requirements. This foresight can prevent conflicts and governance gridlock as the company grows.

3. What is the VIMA position on governance rights and what are the range of options available?

The Shareholders' Agreement in the Venture Capital Investment Model Agreements 2.0 suite of documents (**VIMA 2.0 Shareholders' Agreement**) sets out some model terms for consideration which aim to provide a balanced position on governance rights, taking into account the interest of both founders and investors, and reflecting industry norms. Nevertheless, there is no one-size-fits-all solution for governance rights, as much depends on the specific context and negotiation of each deal.

Director / observer appointment rights

The VIMA 2.0 Shareholders' Agreement provides a simple framework for director and observer appointment rights. Each founder has the right to appoint a certain number of directors, and an investor has the right to appoint a director (and an observer) for so long as the investor holds a certain shareholding percentage. Board seats are typically offered to investors with a minimum shareholding of 10%, and the right to appoint an observer is often available to investors with a minimum shareholding of 5%, albeit these percentages are negotiable. Founders should be mindful to safeguard against an unwieldy board as the company raises more funding and, accordingly, board composition is likely to be re-negotiated and change overtime.

Reserved matter / consent rights

The VIMA 2.0 Shareholders' Agreement seeks to provide a balanced approach with a typical set of board reserved matters and shareholder reserved matters included for parties to discuss. The board reserved matters require the approval of either all, or at least a certain number of, those directors who have been appointed by investors, and the shareholder reserved matters require the approval of holders of at least 50% or 75% of the shares being issued in that funding round (those shares being labelled the 'Series A Shares' in the VIMA 2.0 Shareholders' Agreement). For a more flexible approach, and with an eye on future funding rounds, an alternative for founders to consider is to require that shareholder reserved matters be subject to approval from the holders of a certain percentage of "all preference shares" rather than just a particular class of those shares.

Shareholder reserved matters typically cover structural or ownership issues (e.g., changes to the company's constitution or capital structure, the nature of the business itself, insolvency events, reorganisations or amalgamations) while board reserved matters more often focus on operational issues impacting value (e.g., significant acquisitions and disposals, external borrowings, significant capital expenditures, the approval of or amendments to business plans or budgets, or the commencement and/or settlement of litigation). To help bridge the gap on certain operational reserved matters, one form of compromise that founders may consider is to propose financial thresholds or other triggering events for such matters to require the consent of investors (e.g., capital expenditure in excess of a certain amount).

Whilst the VIMA 2.0 Shareholders' Agreement provides for the reserved matters at both the board and shareholder levels, a founder may also encounter investors who prefer only to have reserved matters apply at the shareholder level, and as such, the list of shareholder reserved matters may include some items that are included in the list of board reserved matters suggested by the VIMA 2.0 Shareholder's Agreement. This is sometimes preferred by investors since shareholder consent rights, rather than at the board level, provide them with more discretion and control – shareholders can act in their own interest and refuse to give consent (subject to any contractual requirement to act reasonably) while directors are subject to their overriding fiduciary duties to act in the best interest of the company.

Both the thresholds and the lists of reserved matters are typically heavily negotiated between the founder and investors, and it is important to agree on a suitable set of reserved matters even during a company's early rounds. Once reserved matters are given, a founder may find it harder to remove any particular item from being a reserved matter.

Information and access rights

The VIMA 2.0 Shareholders' Agreement provides for comprehensive and regular information rights, including monthly, quarterly, and annual financial and operational reports, as well as access to the company's books and records. Such rights could be provided to either all investors, or significant investors with holdings above a certain percentage threshold. Where a higher threshold is used, 5 to 10% is fairly common and would be aligned with the threshold for director/observer appointment rights.

4. Conclusion

Governance rights are an important aspect of any capital raising transaction. They define how investors can participate in and monitor the management and performance of the company and can affect the ability of founders to manage and grow their business. There is no running away from governance rights, and from a founder's perspective, it is often challenging to understand where a compromise can be found. Founders should be aware of the expectations and motivations of different types of investors, and the factors that may influence the bargaining power and leverage of the parties. Ultimately, the goal is to strike a balance between giving investors sufficient oversight and protection and retaining founders' autonomy and flexibility to run their companies effectively and efficiently.

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