KEY CONSIDERATIONS IN FOUNDERS' AGREEMENT

S&P | Singhania & Partners LLP
Solicitors & Advocates

www.singhania.in

A founders' agreement ("Agreement") is contract that is executed between all the co-founders of a company. The Agreement sets forth the ownership, rights, responsibilities, dispute resolution and other terms to be executed between the founders and the company.

Key Terms of the Agreement

1. Equity ownership

One of the most important terms of the Agreement is determining the proportion of equity ownership of each of the co-founders of the company. The equity ownership of the co-founders of the company is determined taking into consideration multiple factors such as the monetary investment, experience, existing intellectual property, know-how and network in the industry. Also, the equity ownership is pertinent to ascertain the voting rights that the co-founder may exercise.

Significant Questions:

How much money is being invested and at what stage in the life cycle of the company? Is the founder also bringing other intangibles along with the money, such as experience, industry connects and credibility?

2. Vesting

One of the important considerations to be taken note of while drafting the Agreement is providing a mechanism to deal with a situation where any of the co-founders exits or is ousted from the company. For this purpose, a vesting structure shall be incorporated in the Agreement detailing the manner in which the shares shall be taken up by the founders.

The vesting of the shares may done in the following manner:

(I) Time Based Vesting

Under time based vesting, the shares owned by the founder shall be vested in proportion to the time spent by the founder in the company. In the event, the founder decides to quit from the company before the expiry of his term, the remaining shares of such founder shall be returned to the company. The Agreement shall state a time period post which the vesting of shares shall begin, say, 6 (six) months or 1 (one) year ("Cliff Period"). One potential problem with the time-based method of vesting is that performance of the founder is not taken into consideration.

(ii) Milestone Vesting

The vesting of shares in milestone vesting takes place when the milestones set out in the Agreement are achieved by the company. This type of vesting rewards performance of the business as a whole. In the event, the founder leaves the company before the milestones are achieved, the shares earmarked for such founder does not vest in him.

Significant Questions:

Whether the vesting of the shares shall be time based or milestones based? What happens if one of the co-founders decides to leave before the expiry of the term of the Agreement?

3.Demarcation of the roles and responsibilities

The Agreement should clearly demarcate the roles and responsibilities of each of the co-founders of the company. Broadly, the roles and responsibilities of the co-founders can be divided as operations, marketing, administration and finance.

Significant Questions:

What are the different roles and responsibilities that each of the co-founders will perform? How will be the accountability fixed?

4. Restriction on transfer of shares

Another important aspect to be taken into consideration in the Agreement is the rights and restrictions of the founders to transfer their shares in the company. The Agreement may provide for a lock-in clause prescribing the number of years before the expiry of which the co-founder is not permitted to transfer the shares owned by him in the company. The Agreement shall provide for a mechanism to deal with a situation where the co-founder wants to exit the company before the expiry of the lock-in-period. It is pertinent to ascertain the method of valuation of the shares and the anti-dilution rights attached to the shares.

One of the ways to ensure that the equity of the company is not transferred to outsiders is by providing the right of first refusal to the shareholders. The right of first refusal will require the founders to transfer their shares to outsiders only once the same has been refused to be taken up by the other shareholders of the company.

The High Court of Judicature at Bombay in Bajaj Auto Ltd v. Western Maharashtra Development Corporation Limited (CDJ2015 BHC 1305) held that in the event there is an agreement inter se the shareholders containing restrictions on transfer of shares of the company, then even if such a company is a public company the restrictions on transfer of shares will be enforceable.

Significant Questions:

What kind of restriction on transfer of shares may be imposed by the company? What shall be the lock-in period of the shares?

5. Intellectual property assignment

In general business practice, the ideas, inventions and other intellectual property developed by a person remains the property of that person. While drafting the Agreement it must be taken care that the intellectual property rights of the co-founders are assigned to the company and the same do not remain the property of an individual. It is not uncommon for companies to obtain trademarks, patents and domain names in the name of one or more of the co-founders initially which later may be transferred in the name of the company. The valuation of the company is affected by the intellectual property owned by it. Further, the Agreement shall contain a clause stating that the intellectual property developed by the co-founders in the course of their association with the company shall always be owned by the company. In specialized high technology sectors, the founder can consider sharing the intellectual property jointly with the company. However, this needs to be well thought out and documented properly.

Significant Questions:

Whether the intellectual property developed by the founder shall be fully transferred to the company or shall it be shared between the company and the founder? How will the valuation of the intellectual property to be transferred done?

6. Value additions by the founders

The co-founders may make value additions in the form of bringing in intellectual property rights, technical know-how, marketing rights or similar value additions in the company. It is important that there is a clear understanding between the co-founders with respect to the nature of such value additions, the monetary value of such value additions, time periods at which such value additions would be made and the compensation to be paid to the co-founders for bringing in such value additions. At times, the co-founders are issued shares against the value additions made by them. The Agreement should clearly lay down the number of shares to be issued, percentage shareholding and the method of valuation of such shares, so that there is no ambiguity pertaining to the same.

Significant Questions:

How many shares are to be issued against the value additions? How shall the value of the shares be determined?

7. Non-compete

The co-founders of the company are expected to maintain strict confidentiality of the business activities of the company and shall refrain from engaging in any business that conflicts with the business of the company. There should be a clear agreement between the co-founders prohibiting them from engaging in activities that are in conflict with the objectives of the company during their association and for a period of a certain number of years after the termination of the Agreement.

It is pertinent to note that section 27 of the Indian Contract Act, 1872 (Contract Act) provides that every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void. The courts in India have taken varied views in enforcing such a clause. It can be inferred that while dealing with disputes relating to non-compete clause under an employment agreement, the Indian courts have considered the pre-termination period of the employment distinct from the post termination period of the employment. Whilst the courts have been tolerant about the application of the non-compete clause, they have walked an extra mile to ensure that such a clause does not have an effect after the cessation of employment and have held that such a clause would fall within the mischief of section 27 of the Contract Act.

In Taprogge Gesellschaft MBH v. IAEC India Ltd (AIR 1988 Bom 157), the Bombay High Court held that a restraint operating after termination of the contract to secure freedom from competition from a person, who no longer worked within the contract, was void. The court refused to enforce the negative covenant and held that, even if such a covenant was valid under German law, it could not be enforced in India.

In Gujarat Bottling Company Ltd and Ors. v. Coca Cola Co. and Ors. [1995 (5) SCC 545 it has been held that "There is a growing trend to regulate the distribution of goods and services through franchise agreements providing for the grant of franchise by the franchiser on certain terms and conditions to the franchisee. Such agreements often incorporate a condition that the franchisee shall not deal with competing goods. Such a condition restricting the right of the franchisee to deal with competing goods is for facilitating the distribution of the goods of the franchiser and it cannot be regarded as in restraint of trade.".

Significant Questions:

What constitutes a competing business? What shall be the period of non-compete so that it is not considered as unreasonable?

8. Confidentiality

The founders by the very nature of their association with the company have knowledge of a lot of confidential information about the company some of which may constitute trade secrets. The founders should be contractually restricted from disclosing any confidential information obtained by such co-founder during the course of his/her association with the company as the same may cause irreparable harm to the business of the company.

Significant Questions:

Whether the company shall sign a separate non-disclosure agreement with the founders? What constitutes the confidential information of the company? What shall be the duration for which the confidentiality obligations will subsist post the expiry of the Agreement?

In Fairfest Media Ltd. v. ITE Group PLC (2015 (2) CHN 704), the Petitioner, an organizer of travel trade shows entered into a non-disclosure agreement with the respondent for a period of 6 (six) months in anticipation of entering into a joint venture agreement with the respondent on a later date. As per the terms of the non-disclosure agreement, the respondent was restrained from disclosing the confidential information for a period of 2 (two) years from the date of the termination of the non-disclosure agreement. The nature of information for which the petitioner was seeking protection related to marketing strategy, customer base, costing and profitability of organizing travel trade shows. Subsequently, when the parties failed to conclude the negotiations, the petitioner prayed for an order of injunction from the court to prevent the

respondent from utilizing the confidential information for a period of 2 (two) years from the date of termination of the non-disclosure agreement. The High Court of Kolkata held that business information such as cost and pricing, projected capital investments, inventory, marketing strategies and customer lists may qualify as trade secrets and passed an order of injunction restraining the respondent from sharing any information concerning the marketing strategy and customer base received from the petitioner for a period of 2 (two) years from the date of termination of the non-disclosure agreement thereby enforcing the non-disclosure agreement post termination. In enforcing the non-disclosure agreement post termination, the court also relied on the principle that a person who has obtained confidential information cannot use it as a springboard for activities detrimental to the person who has made the confidential information. Further, in determining what shall constitute confidential information the court relied on the rule laid down in an English case Saltmen Engineering Co. v. Campbell Engineering Co. Ltd. [1963 (3) All ER 413] which states that an information can only be said to be confidential information when it has been made by the maker who has applied his brain and produced a result which cannot be produced by another without going through the same process.

9. Employment

Generally, the co-founders are required to be in whole time employment of the company. There must be a clear understanding amongst the co-founders with respect to their terms of employment, designation, compensation and benefits to be paid to each of them. The Agreement may contain general understanding between the co-founders pertaining to the same and a separate employment contract shall be entered into providing the detailed terms of employment of the co-founders including the benefits to be provided to each of the co-founders. The employment contract of the co-founder shall contain a non-compete clause that prohibits the co-founder to solicit clients or employees of the company to other entities post his departure from the company.

Significant Questions:

What shall be the designation, roles and responsibilities of the founder? How much compensation and other benefits shall be provided to the founder? What shall be the mechanism for termination of the employment contract?

10. Future financing

The Agreement should clearly contain the detailed provisions for contribution of additional finances by the co-founders for the growth of the company, i.e., whether the additional finances shall be contributed by the founders as equity or as debt, the method of valuation of equity in case the financing is through equity and the rate of interest to be paid by the company in case the financing is a debt financing.

Significant Questions:

Whether the additional finances shall be contributed by the founders as equity or as debt? What shall be the method of valuation of equity in case the financing is done through equity and the rate of interest to be paid by the company in case the financing is a debt financing?

11. Decision making

In the day-to-day functioning of the business, the company may be required to take complex decisions. The Agreement shall clearly state the manner of exercise of simple as well as the substantial decisions. Further, the structure of the board of directors of the company shall be determined. The day-to-day decision making is allocated to the chief executive officer who is appointed by the board of directors of the company. The Agreement is also required to prescribe the procedure which is to be adopted by the company in the event that there is a deadlock in decision making.

Significant Questions:

What shall be structure of the board of directors? How will the simple and complex decisions be made? What will be the mechanism adopted in case there is a deadlock in decision making?

12. Termination and dispute resolution

The Agreement shall lay down the rights of the company as well the co-founders to terminate the Agreement. The Agreement may be terminated upon occurrence of a particular event, i.e., for cause or without any cause by a party or by mutual consent of the parties. Further, the Agreement shall provide a clear mechanism for resolution of disputes between the company and the co-founders with respect to any matter stated in the Agreement, i.e., mediation, conciliation and arbitration. The parties shall agree on the governing law of the Agreement and the exclusive jurisdiction of the courts to which the disputes under the Agreement may be referred to.

Significant Questions:

Under what circumstances shall the Agreement be terminated? How will the dispute between the parties be resolved? Which court shall have the exclusive jurisdiction to try any dispute arising n connection with the Agreement.

OUR EXPERTS

RAVI SINGHANIA
Managing Partner
E: ravi@singhania.in

Ravi Singhania established Singhania& Partners almost two decades ago and leads a team of 70 lawyers including 14 partners. He is a reputed name **in corporate litigation, infrastructure arbitration contractual-commercial disputes, recovery of debts and claims and labour disputes**. Under Ravi's leadership Singhania & Partners features among India's top dispute resolution firm (Arbitration and Litigation). He has successfully represented companies such as Sinosteel Equipment and Engineering Co. Ltd. Boortmalt, Simplot, and Denel (SOC), Case New Holland, Punj Lloyd, IJM Corporation (Berhad) and Oxford University Press in commercial-contractual disputes and related matters.

Ravi is also a charter member of TiE-Delhi-NCR chapter which is an association of start-ups and was founded by successful Silicon Valley entrepreneurs, corporate executives, and senior professionals. TiE has 61 chapters in 18 countries.

ARJUN ANAND
Partner
E: arjun@singhania.in

Arjun is a corporate lawyer with more than 12 years of rich experience behind him. He has handled legal aspects of organization mergers, joint ventures, fund raising, and acquisitions. He has been providing various clients holistic legal solutions on intricate business matters. He featured as one of the top 20 young lawyers of India in the publication 'On the Rise'.

He has advised clients engaged in various sectors including real estate, manufacturing, financial services, hospitality, healthcare, e-commerce etc.

He has extensively advised various private equity funds such as, VisVires Capital, ICIC Prudential Asset Management Company Limited, India Emerging Capital Private Limited etc.

He has advised fortune 500 companies such as SKE&C, Coca Cola India, Serco Group Plc, Gate Group, etc. on their strategic investments in India.

About us

Singhania & Partners (Established 1999) is one of the leading law firms of India providing legal services in Dispute Resolution (Litigation & Arbitration), Corporate and Commercial, M&A, Employment, Infrastructure, Intellectual Property and Project Finance.

Our start-up practice provide advice on matters related to e-commerce platforms, advertising and marketing content, and relevant commercial support. We advise both foreign and domestic entities in investing in start-ups in India. Also, we advise start-ups in structuring their business model to meet the challenges of online sales and the legislations hovering around e-commerce. Besides, we provide consultancy on laws governing business in India. Our esteemed clients include IIM Calcutta, Innovation Park which is the incubation center of this prestigious management institute. Recently, we also advised Balmer Lawrie which is the largest manufacturer of steel barrels in India and is a significant Govt. enterprise with their investments in start-ups in India. Some of the other clients are 99labels.com, B2C2.in; HyperXChange, JazzMyHome, BeatMySalary, Transfast Remittance, **Streetcorner Lending Corp. and Tri-Stage.**

The firm is a sole Indian representative of TerraLex, Inc. (USA) which is a global network of 600+ offices of Law Firms with more than 19,000 attorneys in 100+ countries.

S&P

Singhania & Partners LLP

Solicitors & Advocates

NEW DELHI

P-24 Green Park Extension,
New Delhi 110016, India
t: +91 (11) 4747 1414
e: delhi@singhania.in

BENGALURU

401, Prestige Meridian II,
30, Mahatma Gandhi Road,
Bengaluru 560001, India
t: +91 (80) 4113 1900
e: blr@singhania.in

HYDERABAD

614, Babukhan Estate,
Basheer Bagh,
Hyderabad 500001, India
t: +91 (40) 4210 2424
e: hyd@singhania.in