

# Share Transfer Rights and Control Provisions in a Venture Capital Deal

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**“It is standard for a lead investor to want a seat on the board of directors, to have timely access to relevant information, and to actively participate in the strategic decisions of the company. A seat on the board will be of limited use however without having given due considerations to matters of board composition, voting thresholds and both the substance and administrative framework for board reserved matters. At the same time, start-up founders need to have the space to run their company while delivering on the expectations of their investors. Negotiated well, board rights will be a powerful tool in delivering on the priorities of the investor while allowing the company to be managed by the team the investor believed in.”**

**-Anna Robinson**

In addition to the economics of a venture capital deal, venture capital investors will want to ensure that they receive sufficient rights to exercise a degree of control over the decision-making process of the start-up, as well as a degree of control over the issue and transfer of shares in the start-up. These provisions are included in the shareholders' agreement for the funding round.

## Protective Provisions and Voting Control

Investors will always wish to ensure that their investment proceeds are being employed for the agreed purpose. They would also want to make sure that the start-up does not take certain critical decisions without the investor's approval. These critical decisions are commonly referred to as “reserved matters”, and include any decision to: (i) reduce or otherwise alter the rights attached to the investor's shares; (ii) involve material capital or operational expenditure; or (iii) change the nature of the business. These are three examples of what is usually a two-page list of “reserved matters” in respect of which the investor would reserve a veto right.

Reserved matters typically operate at the board level, where the lead investor in a funding round would be given a board seat. It is a standard approach to have board meetings only deemed to be quorate with the presence of the investor-nominated director, and the “reserved matter” decision would only pass provided the investor-nominated director votes affirmatively on that decision. Reserved matters also operate on the shareholder level in respect of certain key decisions, including those which, as a requirement of applicable law, require the affirmative vote of the shareholders. In this instance, it is common for the “reserved matter” shareholder resolution to require the affirmative vote of a certain percentage of the holders of preferred shares.

# Share Transfer Rights

The mechanics governing transfers of shares of a start-up are of vital importance to investors and founders' alike. These provisions can give shareholders the right to participate in future funding rounds, the right to acquire shares before they are transferred to third parties, or even force the sale of the shares of the minority shareholders in the event of a buyout. They can have a significant impact on the process for selling shares in the start-up, and if drafted incorrectly, can potentially frustrate buyout transactions or at least cause sufficient issues and complications with the sale process.

We have summarised some of the most common share transfer rights below.

## Pre-emption rights

A pre-emption right is offered to existing shareholders in respect of any future issues of shares (or other convertible securities) by the start-up, giving the existing shareholders the first option to purchase the newly issued shares. A pre-emption right typically offers the shareholders a right to maintain (or increase) their ownership percentage by subscribing for new shares on a pro rata basis. A failure by the existing shareholders to subscribe for the shares typically allows the start-up to offer these shares (or any remaining portion that remains unsubscribed by the existing shareholders) to third parties. In certain instances, the pre-emption rights are offered to only a certain class of shareholders, or certain 'major investors' that hold a significant portion of the outstanding preferred shares.

A standard approach to every new funding round is to either obtain waivers from all non-participating shareholders in respect of their pre-emption rights, or otherwise offer the new shares to the existing shareholders first, and then (after the expiry of the period during which existing shareholders may exercise their pre-emption rights) offer the new shares to the new investors.

## Rights of first refusal

A right of first refusal is offered to existing shareholders in respect of any transfer of shares by a shareholder in the start-up to a third party. The right gives the existing shareholders of the start-up a right to purchase the shares being sold before a third party can acquire the shares. In a venture capital transaction, a right of first refusal may also be granted to the start-up in priority to the existing shareholders. In certain instances, the rights of first refusal are offered to only a certain class of shareholders, or certain "major shareholders" that hold a significant portion of the outstanding preferred shares.

## Tag along (co-sale) rights

A tag along (or co-sale) right is typically offered to the holders of preferred shares upon the transfer of shares in the start-up to a third party, particularly transfers by the founder or co-founders. The right gives the investor (as minority shareholder and holder of preferred shares) the right to join the sale of shares to a third party. Investors and founders should be very careful when drafting the tag along right, as the key

players should seek to limit the tag along right to circumstances where a majority of the start-up's shares are being sold, or otherwise in circumstances when the founders seek to dispose of a significant percentage of their shares. Otherwise, any transfer of shares by a minority shareholder could trigger a flood of accepting (also known as "tagging") shareholders.

## **Drag along rights**

A drag along right is usually offered to a majority of the shareholders (or such number of shareholders that can exercise control over the start-up's management and affairs). It is usually triggered upon the sale of the company, which is typically described as a sale of 50% or more of the company's assets or shares. The drag along right gives the controlling shareholders the power to force the sale of the minority shareholders' shares alongside their own. Investors and founders should discuss the appropriate triggers for a drag along right and should ensure that only significant transfers trigger a drag along right.