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Why your startup needs a prenup

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The early months of a startup are like the beginning of a new romantic relationship: full of promise and excitement, with everyone entranced in a blissful state of possibility. In these days of wine and roses, it is natural to want to focus on the positive. Imagining, much less planning for, worst-case scenarios, may be viewed as antithetical to launching a new partnership.

Unfortunately, as too many co-founders and spouses come to realize, the best time to plan for negative outcomes is at the beginning of the relationship. Waiting until conflict develops can be devastating, and too often leads to intractable litigation with no clear winner.

As hard and awkward as it is, it is critical for co-founders to plan for the possibility of future turbulence. At a minimum, startup co-founders should:

- Force tough conversations at the startup stage, and acknowledge the possibility — however remote — that disputes may arise in the future.
- Engage counsel to assist with drafting formation documents that clearly delineate the rights and obligations of all co-founders, including their respective ownership shares and scope of operational control.
- Agree in advance on procedures for avoiding and resolving deadlocks, as well as a process for removing founders or facilitating their peaceful exits.

Don’t put off difficult conversations

There is an endless amount of work to do at the startup stage, and without any revenue coming in, co-founders understandably take on many tasks, working tirelessly (and often without any compensation) to launch their new venture. Carving out extra time to talk about the potential for future discord is the last thing anyone wants to do.

Furthermore, co-founders are often brimming with positivity during the startup phase, and war-gaming for negative outcomes can be viewed as a “vibe killer,” and counterproductive to a successful launch. Pushing hard conversations to another day, when money and time are more plentiful, is always easier.

While it might feel like the worst time to discuss worst-case scenarios, the startup phase is always the best time to confront and plan for negative outcomes. This is true for several reasons.

First, by and large, co-founders during the startup period are on a relatively equal footing. Each co-founder usually contributes (and risks) something, whether it be capital, connections, labor or something else, and no one is (yet) in a position to take credit or assign blame for the business’s ultimate success or failure. Nobody knows what will happen or why, and everyone is at relatively equal risk of failure.

In other words, because it is ex ante, the startup stage is in many ways the easiest and fairest time to plan equitably for the future.

Second, because most startups have not yet experienced success, no single co-founder is in a position to “hold up” the other co-founders or the business by making onerous demands. In fact, this should be disincentivized because it could delay or prevent the launch from occurring. Because everyone is equally motivated to see the business get going, negotiations tend to be easier and more amicable.

Third, most of the time, outside counsel has already been engaged to draft formation documents and other startup materials. It is only a little extra work at this stage for the counsel to address the respective roles, responsibilities and ownership shares of each co-founder, along with anti-deadlock procedures and exit processes.

All of these circumstances may change in the future. As a business matures, the roles and contributions of the co-founders may shift and become unequal. Personal and professional grievances may accumulate, often as a result of such inequalities (whether real or perceived). Such grievances may be exacerbated by the business’s successes and challenges.

Furthermore, a successful business opens the door to a leverage play by one or more co-founders, especially if the governing documents are not sufficiently detailed or lack procedures for avoiding and resolving deadlocks. The consequences of a co-founder dispute can be significant for the business and can create dangerous hold-up opportunities that a dissenting co-founder can use to make outrageous demands backed by the threat of a business-sabotaging dispute.

Finally, it can be difficult, if not impossible, to draft new or revised governing documents once disputes have emerged, because the incentives for agreeing to new terms have shifted substantially.

Draft strong and clear governing documents

Instead of waiting until war breaks out, startup co-founders are best advised to draft strong and clear governing documents at the outset. While it may be tempting to save funds by cobbling together forms found on the internet, it is highly recommended that counsel be engaged to assist with the drafting process.

Corporate structures are becoming increasingly complex and may vary depending on the jurisdiction, industry or type of business. A few thousand dollars spent on professional advice at the startup stage may save tens if not hundreds of thousands of dollars down the line.

What should the governing documents spell out? First and foremost, co-founders should ensure that their respective ownership interests are etched in stone. The extent of each co-founder's equity or membership interest should never be left open-ended or undocumented. Instead, the governing documents should clearly spell out who owns how much of the business.

Trying to rely on collateral promises, conversations, emails and understandings is a recipe for years of litigation. If a term is agreed to, put it in the governing documents, and if a term is not in the governing documents, assume it will never be enforced. The co-founders may wish to consult with their own individual counsel when negotiating the terms of documents that establish their financial interests in the company.

It's equally important to identify the extent to which each co-founder gets a say in major (and minor) decisions involving the business. Often, one or more co-founders will be expected to be the "operator(s)" of the business, and others will have more passive roles. The governing documents should address this clearly.

Agree on procedures for exiting and avoiding deadlocks

Co-founder disputes most commonly arise in two (often overlapping) situations: disagreements about how the business should be run and the exit (or attempted ouster) of one or more co-founders. Most of these disputes can be avoided through careful drafting at the formation stage.

A deadlock can arise when co-founders disagree about a business decision and lack a means for resolving that disagreement. Typically, this results from the lack of a clear tie-breaker mechanism in a company's governing documents.

While it may seem like a good idea at the outset to give each co-founder an equal vote over key decisions, doing so may lead to catastrophic results down the line. The best way to avoid deadlock is to agree on a clearly-defined process for breaking a tie, whether that means empowering one co-founder with an extra-weighted vote, designating someone else (perhaps

an executive or outside adviser) as the tie-breaker, or at the very least, agreeing to a process for breaking a deadlock should one arise.

Flipping a coin, while perhaps not ideal, may be far better than asking a court to weigh in and make decisions for the business — courts are loath to do this. If you read this and are saying to yourself, “Deadlocks won’t be an issue for us; we never have a problem reaching consensus,” just know that there are scores of litigators earning fees to fight over hopelessly deadlocked businesses that started out under similar mantras.

A second, often related “danger zone” involves co-founder exits. What happens when a co-founder wishes to leave? The governing documents should make clear what the process is for transferring, buying out or surrendering a departing co-founder’s shares. Similarly, what happens when a co-founder does not want to leave, but their fellow co-founders have other ideas?

A squatting co-founder can cause intractable problems for a business, most of which can be avoided if the governing documents clearly spell out when and how a co-founder can be removed. Again, the time to worry about this possibility is before it happens; otherwise it may be too late to remove a recalcitrant co-founder without exposing the business to litigation.

In summary, while it may be uncomfortable and draining to speculate about worst-case scenarios when trying to get a new business up and running, the consequences of waiting can be severe and potentially crippling. It is best practice at the startup stage to soberly confront the potential for disputes in the future, work with outside counsel to plan for and agree upon processes for dealing with negative contingencies and document those agreements in strong, clear governing documents.

Nobody wants to think about a prenup while planning a wedding, but it is by far the best time to address the complications that all too often follow the honeymoon.