PURPOSE®

Investment today, steward-ownership tomorrow

What to consider during fundraising if you want to keep the option of implementing steward-ownership in the future

If you want to keep the option of implementing steward-ownership in the future, there are several factors to consider during fundraising. While it may not be currently feasible for some companies to adopt steward-ownership, they still desire to keep this path open for the future. For this, it is crucial to be aware of a few factors when structuring investments, especially prior to financing rounds, to ensure that it is still possible to make this decision later:

Retain the majority, preferably all, of the voting rights.

The implementation of steward-ownership requires approval with 100 percent of the voting rights. This means that even a shareholder with few voting rights can block this step. The safest option would therefore be not to grant any voting rights and also to avoid giving out special rights and far-reaching approval rights. Certain consultation, information, and approval rights can however still be granted for selected transactions.

Actively holding voting rights is important to some investors in order to strengthen their emotional ties to the company. This is especially true for investors who are very involved in the company. It may be possible to cultivate this bond through functions such as a legal or non-legal advisory board (for further information, see this document on Distribution of Voting Rights and Steward-Ownership). Another alternative is consultation duties, which enable the investor to be heard on certain issues without being able to legally block the decision.

Avoid including significant minority veto rights and transactions requiring consent in the contracts.

In many contracts, strong minority rights or consent requirements for investors are included by default. Make sure that key business decisions are still made by people who are truly connected to the company and cannot be blocked by the minority rights of investors. The same applies to transactions requiring the approval of the investors, for instance when even certain expenses, new hires, etc. are subject to a veto. It may well be that the granting of individual rights to investors makes sense in specific cases. However, if the number and degree of detail of transactions requiring approval become excessive, the company's entrepreneurial flexibility and autonomy can be restricted. Therefore, when designing contracts, keep the investor rights at a level that makes sense based on the needs of the investors and the company while not giving away too much power.

Make sure that investors cannot indefinitely participate in profits, that their profits are capped and / or that the decision rights for distributing profits are split from the economic rights of receiving the dividends

In steward-owned companies, it is certainly possible for investors to achieve high returns on their investments. However, these are typically capped, which means that it is not possible for investors to participate in the profits of the company "indefinitely" based solely on an initial investment or that the decision rights for distributing profits are split from the economic rights of receiving the dividends. Therefore, when taking the step towards steward-ownership, it must be clarified that the investors' return is capped - from the time of conversion at the latest. In most cases, this is also a condition for new investors after the company has entered into steward-ownership. Finally, it is the common goal to invest the profits for the purpose of the enterprise after providing a suitable return for the investors, founders and early employees. If, however, investors have already been promised unlimited profit participation, this will lead to difficult negotiations—which brings us to the next point.

Use financing instruments in which the investor's return is not dependent on the company's valuation but is fixed or linked to key figures

All investors depend on converting their investments back into liquidity. For this purpose, they often equate the value of their investment according to the valuation logic with the potential amount for which the company could be sold, the company valuation.
The company's valuation is often decoupled from the actual sales and cash flow of the company, especially in the case of companies that could potentially become very large in the future. If investors insist on this value, it can often only be realized through a company sale or IPO (see below) which creates a forced growth trajectory. If possible financing instruments should be used in which the liquidation proceeds of the investors are fixed or linked to key figures such as cash flow rather than the company's valuation and the liquidity should be generated from free cash rather than selling the company. If a valuation method is used, make sure that you use (and fix one) one that does not inflate the valuation and makes it practically impossible to buy back the investors' shares (without forcing the company into a growth trajectory that is not healthy)

Discussions about a fair multiple, yield or interest rate are more relevant to the step that may follow later. Nevertheless, valuations can be used for structuring if necessary.

Enable investors to get their money back without having to sell the company by thinking about a 'structured exit' from the beginning.

Typically, investors in startups realize liquidity through the sale of the company or an IPO, making it less likely to pursue steward-ownership. To keep this option open, it is crucial to plan for a "structured exit" at the beginning of the financing round. This entails developing a well-thought-out path for investors to exit that is not reliant on the sale of the company. Possibilities for this include repurchase rights or contractually agreed repayments, limited dividend rights, or direct debt instruments, such as subordinated loans, silent partnerships, or profit participation rights or tag-along and drag-along rights for the entrepreneurs that allow them to make the decision towards SO themselves.

Think carefully about how much money you really need for the next step and do not take on more than your company can handle in the future.

With the above points in mind, you should make sure that you only raise as much as your company can carry in the future. Capital costs—the costs it takes to buy out the investors—are high. This calls for good planning of the next steps. In our experience, entrepreneurs tend to raise more capital than necessary. In addition, the option of an additional financing round, perhaps with better conditions based on further product development, is often not considered enough.

Communicate clearly where you want to go.

If you are already sure that you want to implement steward-ownership at a foreseeable point in time, then it is important to clearly communicate your plan or intention to investors so that no unpleasant surprises (on either side) occur later. Even if you are not sure yet, but still do not want to sell, communicate clearly and explicitly: there will be no sale of the company, the liquidation proceeds must come from cash flow, there will be no voting rights.

If these points are observed and communicated during financing rounds, the door is open for a later conversion into steward-ownership. In any case, the company can continue to be managed by the entrepreneurs in an autonomous manner.