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Issues That Can Arise When Tech Founders Leave CEO Role

By **Alex Leibowitz and Megan Monson** (October 31, 2023, 5:14 PM EDT)


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A lot can go wrong when the founder of a venture-backed technology company ceases being CEO.

As the time it takes between forming a business and selling a business or conducting an initial public offering stretches longer, more founder CEOs are transitioning out of the role earlier than before.

This frequently results in several predictable, but often unanticipated, consequences. This article identifies legal issues to consider when a founder CEO transitions out of the role.

Founders of venture-backed technology companies are often entitled to designate or elect one or more members of a corporation's board of directors. Many founders designate or elect themselves to the board.

When a founder ceases being CEO, parties should carefully review the company's certificate of incorporation, stockholders' agreements and the founder's employment agreement, if any, for provisions related to board size and composition, and also consider board dynamics.

Board Position

A founder may own enough shares to designate one or more directors pursuant to the company's certificate of incorporation, but a stockholders' agreement might (1) condition this right — or the founder's right to designate themself to the board — on the founder continuing to provide services to the company as an officer, employee or consultant or (2) disenfranchise former employees when it comes to designating directors.

Maintaining the status quo of terms negotiated years prior when circumstances were different may no longer be appropriate — it might allow a disgruntled former employee to disrupt board business, or it might shift the right to designate one or more directors from the founder CEO to a small group of employee stockholders.

When a founder ceases being CEO, parties should consider whether the founder should remain on the board or entitled to designate one or more directors as well as whether amendments to any stockholder

or employment agreements are necessary or appropriate.

Parties should consider whether the amount of equity owned by a founder CEO and the thresholds to amend the company's certificate of incorporation and stockholders' agreements will make raising capital or corporate governance easier or more difficult.

For example, a founder CEO who ceases being an officer, employee or consultant may become disenfranchised under a stockholders' agreement and no longer entitled to vote on amendments, and it may not immediately be clear whether this is good or bad.

Founder Equity Ownership

Another common issue arises when a future investor takes issue with a former employee having an actual or practical ability to block future financings, even if a transition was amicable; however, this may still be preferable to soliciting votes from a large number of stockholders who each owns a small number of voting securities who may not be informed about the business or responsive.

When negotiating a founder CEO's transition, consider whether the parties' interests are aligned or misaligned, the relative needs of the parties, including the timing of those needs, and whether there is opportunity to compromise.

Founders of venture-backed technology companies are frequently asked by early-stage investors to subject a portion of their equity to time-based vesting contingent on remaining an officer, employee or consultant of the company through the vesting period. In addition, some founders receive option grants or restricted stock units or purchase restricted stock subject to similar vesting conditions.

In each case, when a founder ceases being CEO, depending on previously negotiated terms and whether the founder will remain an officer, employee or consultant, vesting may cease — or even potentially accelerate — and unvested equity may become subject to repurchase or forfeiture. Parties should carefully review offer letters, employment agreements, equity award agreements and equity purchase agreements in order to confirm the treatment of the equity.

When a transition is amicable, parties may want to consider modifying vesting or repurchase rights and extending option exercise periods, potentially in exchange for a release of claims in favor of the company, as well as any potential tax consequences.

Succession Planning

Interviewing CEO candidates and negotiating compensation terms can take months. Depending on other senior level vacancies, the CEO may be filling multiple roles that need to be filled first or simultaneously. If key contracts are coming up for renewal, consider how customers may respond to news that the founder has departed.

Founders who express a desire to transition out of the CEO role prior to the sale of the business or an initial public offering may want to remain employed by the company they founded. It is important to understand why.

If it is to pursue a passion project that will benefit the company it may be worthwhile, or if it is to maintain health insurance until they figure out their next move, it might be acceptable; but if it is

because they don't trust the new CEO, think twice.

Additional Considerations

The parties may also want to consider the following additional considerations when negotiating a founder CEO's transition:

- If the founder serves as the chairperson of the board of directors, who should serve as the chairperson going forward?

- Will the founder be eligible for employer-sponsored health insurance? The answer will likely depend on classification — employee vs. independent contractor — and number of hours worked in the new role, although some providers will make exceptions.

- Has the founder executed an inventions assignment agreement, assigning all of their inventions related to the business to the company? If not, the company should request one.

- Is there confidential information of the company in the CEO's possession that needs to be returned or destroyed?

- Companies frequently request nondisparagement agreements from departing executives, but when faced with a request to make it a mutual obligation, many parties give up when they are unable to agree who should be covered by the company's obligation, e.g., board members, officers, employees, stockholders, etc.

- Has the executive accepted a loan from the company, and will that loan accelerate and become repayable?

- If transition services are needed, consider whether a short term consulting agreement is appropriate.

Once the parties have reviewed the relevant agreements and identified the important issues, each party should develop a strategy and timeline for negotiating the founder-CEO's transition, on-boarding of a new CEO and how to communicate the transition to the company's workforce.

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