

CHAPTER 15

Understanding Ownership, Dilution and Rounds of Financing

“Less is more”

A motto for minimalist philosophy

Dilution means being left with less of something which was more earlier. So, dilution of authority would mean having less authority than before and dilution of control would mean having lesser control than you had earlier. If you are asked to dilute your ownership, you are being required to give up a part of your ownership as well as the rights associated with that ownership.

In the case of a corporate entity, its ownership is vested in its shareholders who subscribe to its “ordinary” or “common” shares. Corporate laws require that every private company shall have at least two shareholders, even if one shareholder owns only one share of the company while the rest are held by the other. Thus, what percentage of shares one holds is not dictated by law. However, the shareholders may, if they so decide, seek to limit shareholding percentages through a shareholder agreement and / or by providing for the same in the company’s articles of association. What the law does define is that any decision taken by shareholders of the company will be put into action only when shareholders holding at least 51% of the shares have voted in its favour. The law also defines that certain decisions are of fundamental nature and such

decisions require that at least 75% of the shareholders vote in their favour before these can be acted upon by the company. The list of decisions that can be made with a simple majority of 51% (through “ordinary resolutions”) and those that require 75% votes (through “special resolutions”) under the Indian Companies Act, 1956 are listed below in Annexures 15.1 and 15.2 respectively at the end of this chapter.

So the question of who should have what percentage shareholding in the company does become important. The holder of at least 51% shareholding in a company has the right to appoint directors on the board of the company including the chief executive officer (CEO) or the managing director (MD), who is vested with substantial powers to manage and control the affairs of the company.

However, in case of VC investment in the company, the VC does not have equity control of the company as he usually does not own majority, that is, more than 51%, shareholding in the company. His shareholding in the first round (Series A) of VC funding is usually likely to be in the 25% to 35% range, which under law does not give him control of the company. In return for a stake in the company the investor requires as much protection as possible to protect its capital, without being involved in the day-to-day decision making process. For that reason, the VC always seeks the right of veto over key decision-making, namely in those decisions which may have a serious impact on the finances or strategic direction of the business.

In some cases of start-ups, the term sheet for investment may even vest the VC with the right to take complete control of the company if the first sale does not take place within a year of the investment.

The point to note here is that post the VC’s investment, the percentage of shareholding and management control usually gets “decoupled”. The control of the company will almost always be defined by contractual arrangements rather than by percent ownership.

How Does Dilution of Equity Take Place?

Dilution of equity takes place when an investor invests in your company by purchasing its equity shares. For instance, if you own 100% of the company and after you have received the patent for a product that you have invented, a VC investor buys 40% of your company for USD 1 mil-