

## Outside Counsel

# Dispute Prevention and Resolution Options That Can Save Start-Ups From Failure

**B**y their very nature startups are risky projects. Startup founders can have great ideas but monetizing those ideas requires a specific skill set that often doesn't reconcile with those of the risk-taker mentality of entrepreneurship. The unfortunate truth is that for every Facebook there are hundreds, if not thousands, of failures. One would think that lack of funding would be the primary factor threatening success. However, according to a study conducted by Harvard Business School professor and author of "Founder's Dilemma," Noam Wasserman, 65% of startup failures are the result of disputes amongst cofounders. That's significant, to say the least. Seed investors generally know that their investment comes with the expectation that they will back the investee by leveraging their own network to open doors, share their expertise and insights and, generally, support

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the investee company and its founders as needed throughout its life cycle.

Few investors realize that one of the most important steps they can take to help secure their investment is to push founders to structure a dispute prevention and resolution structure early on to avoid the interpersonal conflicts that statistically lead to failure.

New companies are built on new ideas and people in new roles executing those ideas. Both are necessary ingredients for success but also common ingredients for failures. The manner in which founders deal with each other will often determine growth success and survival potential. The pitfalls of those types of relationships are very similar to those that make, or break, any other relationship.

Think of it as a marriage and ask yourself: Do the partners share a same

long-term vision for their success? Do they have the will and tools to overcome personality clashes? Are they both committed to the relationship and its survival? Are they willing to take a back seat to each other at times and step up and lead at other times? Do they both feel like they are getting their fair share? Are both partners pulling their weight? Are their financial and risk appetites significantly different? And, most importantly, do they share a will and the ability to deescalate and, eventually, resolve small and big disputes? These are all questions we ask ourselves, or maybe should ask ourselves, when committing to any long-term relationship. Founders should, yet seldom do, pose similar questions when deciding to get into business with each other.

### The Founders' MO

More often than not, success and quick growth can mask and, invariably, amplify and accelerate conflict as soon as a "trigger" arises. Fortunately, there are a number of ways to try to prevent the occurrence of disputes and constructive ways to address them

should they arise. First and foremost, at the onset, founders would be well served to put on paper the specific type of relationship they envision. It could be in the form of a binding shareholders' agreement but I prefer a separate, more informal document, which I refer to as the Founders' Modus Operandi, or Founders' MO. The Founders' MO isn't meant to protect legal rights but is a genuine attempt to push the parties to think through their relationship. It could be shared with startup financiers and even potential investors. It's a good indicator of founder state of mind, focus and resolve to avoid lethal conflict.

The goal is to agree early on, openly and candidly, on how best to move forward to preserve each person's desire, ability and energy to commit to the contemplated business. Simply put, founders are asked to flesh out working plans, aspirations and expectations to alleviate the risk of conflict and accompanying failure as the company evolves.

### **What To Include in a Founders' MO**

Each Founders' MO should be tailored to the specifics of the persons involved and the type of company they envision. I favor putting as much as possible in the document. That in itself pushes parties to think through early on what is important to them, to discuss issues calmly when they diverge and to find constructive ways to resolve differences before they become disagreements and clashes. Basically, it's a healthy exercise to go through on all levels.

Obviously, it should be used to clarify roles and responsibilities, financial splits, decision making process and gridlock resolution. But it shouldn't be limited to those items. If having bagels in the morning for the staff and not fruit in the afternoon is key, then bring it up, discuss it and include whatever is agreed. If attending weekend activities with your children precludes you from putting in work time on weekends, list

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it and agree work time commitments and more generally what each partner expects and can put in. If you have a five-year plan within which you want to build, grow and exit, then speak up and deliberate.

Essentially, discuss and include in a Founders' MO everything that truly matters, from the key financial and strategic business matters to the personal desires, constraints and idiosyncrasies. Work on the Founders' MO initially over a couple sessions; once you start you will likely realize that you need time to think about some items on your own before you can articulate your position to your partner.

### **Updating the Founders' MO**

The Founders' MO must be an evolving document. In this sense, think of the startup as a child, and you, as one of two

parents responsible for its well-being and growth. As with a child, start-up needs will evolve with time. That's why setting regular timeframes for the parties to reconvene and reconsider their relationship and the initial document they agreed is essential. It's also why I favor not relying solely on a traditional legally binding shareholders' agreement but rather focusing on the more informal Founders' MO. Such a document can be discussed, revisited and changed easily and quickly by the parties as needed.

I often suggest that founders plan to revisit their Founders' MO initially monthly, then, as they learn how to work together, quarterly and eventually, bi annually. I don't recommend waiting any longer to test its effectiveness: if the start-up is operating as expected and growing as anticipated then things are moving and changing quickly requiring that the Founders' MO be revisited and updated to address the evolving working environment; Conversely, if growth is slow, revisiting the Founders' MO in a timely manner may be even more important to try to identify any founder issues that are hampering growth.

### **Including a Trusted Third Party**

Although some founders will be tempted to go at it alone, an independent third party may be particularly helpful. Ideally, it would be a dispute prevention professional. I recognize that bringing someone in from the outside may prove to be financially burdensome. It could also be seen as an unnecessary additional time-consuming exercise,

an extra person with whom calendars and meetings must be coordinated. My view is that the benefit outweighs these burdens, which can be alleviated by bringing someone in early on and selecting a professional both parties respect and trust and who will know to be both prompt and flexible when the need arises. In hindsight, it may prove to be the best time and money investment founders, and their financiers, make.

A third party will be in a better position to push the parties to discuss and think through, in a productive way, the tough matters that we generally want to avoid bringing up. They will also be of invaluable support in identifying party interests that tend to be intangibles of primary importance but masked by the traditional financial and legal positions. Those types of interests, such as perception of fairness, respectful work environment and deference for specific matters, are unfortunately often the silent trigger to lethal conflict.

They can also be the “easy” solution once identified and addressed. An independent third party will also generally be able to help the parties craft solutions that grow the pie and steer the parties away from zero sum outcomes. And, obviously, they will have the benefit of being removed from the situation and able to see the big picture in an objective way to both find and explore potential pitfalls.

### Handling Disputes When They Arise

A key component of the Founders’ MO will be to agree one or more dispute

resolution mechanisms. These need not mirror the provision parties include in the more formal shareholders’ agreement. Some items may have a specific resolution mechanism— for example, survey the staff to decide whether it’s bagels in the morning or fruit in the afternoon. Others should be handled by a more traditional mediation effort. Ideally, if an independent third party was brought in to craft the Founders’ MO, that person would serve as the mediator if and when conflict arises.

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Think of it as a marriage and ask yourself: Do the partners share a same long-term vision for their success? Do they have the will and tools to overcome personality clashes? Are they both committed to the relationship and its survival?

The key is for all constituents to work on resolving their disputes themselves with the help of the mediator to avoid both courts and a collapse of the start-up. Start-ups rarely have the financial strength and human capital commitment needed to survive a court process. I can’t emphasize enough the importance of identifying and resolving issues early on. This is where I would argue that even the most passive investor must step in and push all parties to work quickly, efficiently and in the company’s interest to resolve their disagreements.

Mediation is often the last chance the constituents have to save the start up from failure. The mediator will be able

to work with the parties in the same way they worked with them on the Founders’ MO: identify interests, grow the pie, craft workable solutions, think outside the box when needed and visualize wins and successes as evolving over time and not in a static timeframe.

Investors and founders must recognize that conflict is not only normal but to be expected. I would worry if no conflict is said to arise; that in itself is a red flag that people are likely in denial and that there’s a significant risk of quick and shocking escalation and detrimental action once a “trigger” arises. Dispute prevention should be of primary importance to founders as well as those who finance them.

The key is to have a plan of action, agree and ink roles, responsibilities, working behaviors, objectives, financial commitments and split, decision making process, gridlock resolution and other dispute avoidance and resolution strategies. Time is of the essence—catch a disagreement early and nip it in the bud before it snowballs and deteriorates. Focus on de-escalation, resolution and prevention for the future. And, most importantly, don’t avoid dealing with it—that in itself could prove lethal.