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This Certifies that_________________________is the registered holder of_________________________shares transferable only on the books of the Corporation by the holder hereof in person or by Attorney upon surrender of this Certificate properly endorsed.
In Witness Whereof, the said Corporation has caused this Certificate to be signed by its duly authorized officers and its Corporate Seal to be hereunto affixed
this________day of__________A.D.____

PRESIDENT
SECRETARY

HUBCO, NEW YORK

a primer on
Early-Stage Company Equity

[From Raising Capital to Stock Options.]

Seldom taught things an entrepreneur
needs to know about equity and governance
before making needless mistakes.

Dennis J. Cagan

CAGANCO
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About the Author

Dennis Cagan is a noted high-technology entrepreneur, executive, and board director. He has founded or co-founded over a dozen different companies, taken some public, been a CEO of both public and private companies, a venture capitalist, a private investor, a consultant, and a long-time professional board member – over 67 corporate fiduciary boards. He is in the IT Hall of Fame, and his book, *The Board of Directors of a Private Enterprise,* released in 2017, is considered by many to be the most authoritative perspective available on private company boards and governance issues.

Mr. Cagan is a recognized authority on corporate governance, boards of directors, entrepreneurship, information technology (including mobile applications, Internet, infrastructure, e-commerce, software, hardware, systems, cybersecurity, and communications), in the disciplines of governance, strategy, distribution channels, sales/marketing, and services.

Mr. Cagan is primarily engaged in management consulting. He also provides his trademarked **Shadow CEO®** services entailing one-to-one support to private company owners and CEOs through Caganco Incorporated. All are comprised of an intense side-by-side, hands-on approach to helping C-level executives go beyond their current experience set. In the area of corporate governance and boards of directors his services are available through GovernX LLC. The firm primarily works with private company ownership and leadership to develop and manage world-class governance through boards (both fiduciary and advisory), and its unique Governance Forensics which uncover loopholes allowing for desired changes in company ownership.

Mr. Cagan has been a regular contributor of feature articles in a variety of business publications and is one of the only authors to have been published in the four most popular board magazines: Directors & Boards, NACD Directorship, Family Business, and Private Company Director. He speaks widely on the subject of boards of directors and governance, including keynoting the inaugural Private Company Governance Summit, in Washington, D.C. in 2013, and speaking again in 2014, 2015, 2016 and 2019.

During his career Mr. Cagan has actively done business in 35 countries. In 1976 he founded the David Jamison Carlyle Corp. (his 5th start-up), turning it into one of the country's earliest and largest distributors of computer peripherals. After being included in *Inc. Magazine's* very first Inc. 100 listing at #32, he took DJC public (DJCC: NASDAQ) in 1981. Since 1983, in addition to his consulting, Mr. Cagan has served as an interim C-level executive dozens of times – often for companies where he was already a member of the board of directors.

Mr. Cagan currently sits on several technology company boards in in cities spanning both coasts. The course he teaches at SMU Cox School of Business, Business

Leadership Center, *Governance and Board of Directors 101*, has been awarded a Teaching Excellence Award every year. Dennis is married with four daughters, has an Honorable Discharge from the USMC, and studied Economics at UCLA.

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a primer on

Early-Stage Company Equity

*In the 1990's, before the 'tech bubble', there was a Silicon Valley joke: A sign on the counter of a local deli read, "**Sorry, We Do Not Accept Cash or Credit Cards – Only Stock Options**." Those days are far behind us, but today, more than ever before, stock options and other equity incentive instruments, have become a common and vital element of compensation in a majority of the early-stage companies that have the objective of a liquidity event (selling the company) in their future plans. However, few compensation alternatives in today's workplace are less understood, particularly for employees that have never experienced them, and entrepreneurs who have never provided them.*

This piece will talk about equity. It covers everything from raising capital to stock options. How you get equity in the first place, how to distribute it, how to retain it, and how to maintain long-term control of the early-stage enterprise that you are starting.

The Right Advice

S. Prestley Blake, who co-founded the Friendly's restaurant chain in 1935, never hesitated to introduce himself to more famous people. Seeking business advice, he called on James Cash Penney at the retailer's office in New York and Harlow Curtice, a former president of General Motors, in Michigan. "Don't be afraid to ask other people for advice," he advised in "A Friendly Life," his 2011 memoir. He passed away in 2021 at the age of 106.

Getting advice is always a valuable attribute for entrepreneurs, however even more important are two additional considerations – *who are you getting the advice from* and *determining if you want to actually take the advice*. It may seem obvious, but all advice is not equal. Many well-intentioned founders idealize a culture of transparency – which is admirable, especially when contrasted with a dictatorial one.

That's not what you were missing

In 2006 I was asked to step in as the interim CEO of an insolvent but operating company. The firm was still publicly traded, and in fact Sarbanes-Oxley compliant, however the once thriving company had previously been badly mismanaged under the ownership of a major private equity backed rollup.

On my first day in the job, I called for an all-hands meeting in the atrium of the 250,000 sf headquarters building. I addressed all the employees telling them who I was, and that I was going to work to get things back on track, and retain as many jobs as I could, and then recruit a long-term CEO. One young man in the back of the crowd called out a question. "Sir, what qualifications will you be looking for in a that long-term CEO?" I responded, "The right person will have led a public company, a technology company, have good people skills, and be decisive." The young man then asked, "Sir, wouldn't you be looking for someone with experience in the workplace training business?" I said, "No, why would I do that?" He quickly said, "Sir, that's the business we're in." I looked directly at him and stated, "I know that, but I am looking out at 225 people who know that business. That does not seem to be what you've been missing."

The point? A business leader needs to assemble a team that covers all the key skills and experience that contribute to success; and then have the ability to access and arbitrate the input from the team as a whole to arrive at key decisions. Further, whatever the skills and experience that your team has, if you can access even more skilled and experienced counsel, in the form of advisors, you should always do so.

However, as an organization grows it becomes much more cumbersome and even problematic to try to extend that policy as a whole into an expanding company. Leading a company is a delicate and challenging job. Someone has to make the final call. As a CEO when faced with a decision on which technology base to build your application on, would you weigh the opinion of your marketing executive the same as your CTO. No. Or, would you give the opinion of your CTO the same as your marketing person in a decision on the design or color of your company logo. No.

What do the best advisors look like? Expert knowledge and experience in the subject that they are advising on. As noted above, a marketing expert is not likely to be as qualified to advise in technological subjects as a CTO, and vice versa. Would you ask your attorney for medical advice, or your doctor for legal advice? One frequent misalignment of advisors involves lawyers and accountants. Each is licensed to give advice in very specific areas – the law and financial accounting. While there are certainly lawyers and CPAs that have deep business experience (particularly if they have been practicing for a long time), however that is not their area of primary knowledge. Have they started companies that developed an e-commerce platform, food or other product?

Have they built a team, struggled to make payroll, developed a product, marketed and built a base of customers and revenue – beyond their particular professional services practice?

Some of the best advice you will ever receive is to seek out counsel in the form of a board directors, or advisory board, or simply ad hoc consultation, in the areas of business that are critical to your task of building your enterprise. Some examples of critical areas of advice include (alphabetically): capital acquisition, corporate governance, customer support, engineering, facilities, finance, financial projections, geographical, hiring/firing, human resources, industry expertise (specific), investor relations, leadership, legal, M&A, manufacturing, marketing, negotiations, operations, out-sourcing, regulatory compliance, risk, sales, strategy, technology, and more…

It is up to you to make sure that an advisor is truly qualified to opine on a particular subject. This is something where actual experience can out-weigh degrees like MBAs or Ph.Ds. or licenses like legal, CPA or MD. Great advice is out there and often available for the asking – often even free for the asking. In the field of entrepreneurship and start-ups, and building commercial enterprises, the best knowledge comes from experience, and unfortunately, from making mistakes and learning from them. When building a company everyone will make mistakes, why not at least minimize yours by learning from others?

The right advice at the right time – or missing advice

In my role as a Shadow CEO® and governance expert I hear almost monthly from entrepreneurs, who have gotten advice from other founders (but not experienced it themselves), "Don't take money from a venture capitalist, because they will steal your company and throw you out." Let me set the record straight here. Venture Capitalists are not in the business of stealing companies. They are in the business of investing in companies with great ideas, and great management teams to execute on those ideas. And they are extremely seasoned negotiators of investment terms – way better than most entrepreneurs. They do not steal companies. However, they have been known to orchestrate the 'replacement' of senior management that is not getting the job done, and not executing well enough. They don't like to lose their money, and if they feel that is a risk, they take action. So, when a founder gets demoted or fired, how can it be done if they were the founders, and who's fault is it?

On the surface, the answers are easy, but underlying the actions are a number of complicated dynamics. First, any investor or combination of investors who have majority control of a company can usually take most actions they wish. They may even have some of these rights as minority shareholders. Whose fault is it? There is only one answer here – the entrepreneur themself.

This has two parts. Part one, the founder may not have been continuing to contribute to the company's success. Perhaps they were just not up to the job of running the show; or sometimes they are simply causing descension or disruption – well publicized examples of each abound. Regardless of what precipitated the dismissal, it remains still the entrepreneur's fault for another basic reason.

Part two, going back in time to the day the VC first invested in the company. Most likely there was a group of folks sitting around a big shiny conference table at some law firm's office. On one side of the table was the VC, and on the other was the entrepreneur/founder. Perhaps both sides even had their lawyers there. The VC proceeded to push an investment document across the table, and the entrepreneur signed it. Buried within that document were terms and conditions that gave the VC the legal ability to later dismiss the entrepreneur.

Whose fault was it that the founder signed that document, without getting the best advice? They signed the deal lacking proper insights into the long-term meaning and ramifications of the terms of the agreement. They did not adequately understand what they signed. But the deal they signed gave the investor(s) the rights to do whatever they did. Maybe they were just in a hurry to get the funds, perhaps not. But they signed it without fully understanding what powers they were signing over.

[See the section below on Protecting Founder Control.]

Equity Distribution

The number one way to get equity in a company, and the most straight forward, is to simply buy it. Individuals, both accredited and non-accredited, sometimes termed ‘friends & family’ or ‘angels’, purchase shares or units in start-ups every day. But that is definitely not the only way to participate. Many non-investors get early-stage equity in exchange, one way or another, for contributing their efforts to the company. Whether as an employee working for reduced or no salary, or an advisor providing valuable experience-based insights, or a vendor providing products or services for below market prices, all these folks can be granted or awarded equity in lieu of cash for their contributions.

As an enterprise grows and can increasingly afford to pay market-rate salaries and bonuses to its employees, it is still exceedingly common for firms to also grant equity, which holds the added incentive of the prospect of dramatic increases in value over time. Stories abound over the years of people getting a few stock options early-on in a company’s formation, and then being able to sell the equity, for millions of dollars – either as a result of an initial public offering (IPO) or the acquisition of the company by another firm.

It is rare for a first-time entrepreneur, and sometimes even serial entrepreneurs, to fully understand the complex strategies and dynamics of efficiently allocating capital, much less understand the intricate mathematical calculations usually involved.

There are typically several phases of equity distribution during the life cycle of any company.

- **Initial founding** – the founder(s) grant themselves a certain number of shares (or for LLC -units, or a given percentage of the LLC) when the firm is created.
- **Seed investors** – the very earliest investors, usually friends and family or angels, put in some actual capital to help finance the development of the product or service and build the company. Their money can buy them straight equity (a number of shares) or it can be in the form of a loan (which usually does not include equity), or frequently some form of convertible loan (which is considered a loan until the company raises more capital later at a specific price). At that time the loan is then automatically converted into equity at a discount to that later price.
- **Required personnel** – the founder(s) need other people to help them, particularly those with skill sets that complement the founder's – e.g., software engineers, marketing, sales, finance, etc. Since funds are very limited, these people are usually compensated completely or in part with equity.

- **Repeat cycle** – more cycles of a combination of more investors (capital) and more people (talent).

A small % of a big number

In the mid-1990's a sole founder funded the start-up of his company by charging expenses on his VISA. By the time he raised outside capital to continue to fund his growth, he had run up charges that totaled 150% of his entire net worth at the time.

He continued to raise capital and grow the company. Each funding round further reduced his percentage of ownership (equity). However, just a few years later – early 2000, he sold the firm for a package totaling just under $5 billion.

Not bad at all, even though by the time of the sale, because of his various financings, his ownership had been diluted to under 5%.

Today, there are a variety of funding and governance strategies that allow entrepreneurs to retain much larger ownership positions, and even high degrees of company control, even as they distribute large amounts of equity to subsequent investors and employees.

While it is not uncommon to see early employees making millions of dollars, it is also not unusual to see founders who started with 100% ownership of their company, yet still end up with a very small percentage before getting any liquidity.

There are any number of key questions that any entrepreneur – or other early-stage company participant – should ask. For each one there is more than one answer, and each answer can have a magnified effect on the equity ownership dynamics of your company. **Founder beware.**

- How many shares/units did you authorize when you started the company?

- How many shares/units did you issue to yourself (and others)?
- Did you then later contribute cash, or other items to the company?
- What happened to the money and items you put into your company? Were they recorded on the 'books', if so, how?
- Have you accounted for the time and work you have contributed for no salary? How?
- How have other people's financial and non-financial contributions accounted for on the company books?

Starting a company and guiding it through its growth to a satisfying exit – liquidity event of some type, has evolved a great deal from the 'old' days when you simply just think of an idea, develop your product or service, get a few customers/users (paying or even not paying), and then sell it. Everyone can name dozens of dynamics that come into play these days – from start-up to exit. However, one of the most important, yet least understood, least articulated and least properly addressed by founders, is the distribution of equity.

Using Equity as an Incentive

From the time a company is founded, to the time it is a multi-million dollar thriving firm (if it is that fortunate) it goes through alternate cycles of the relative value of cash versus that of equity. Whichever one it has the most of, is the least valuable. Before it raises meaningful capital, money is more valuable than equity (it can issue large numbers of shares, as long as they were originally authorized)[1]. When it has raised a healthy round of capital, its equity becomes more valuable, since it can now afford to pay cash to its employees, vendors, and other contributors. This cycle can repeat itself several times over the life of a company. Certainly, one concern of founders and senior executives is dilution – the situation where more shares are sold or granted to investors or employees, and the insiders' percentage of ownership is diluted, or reduced. One important thing to remember here is that no matter if you use equity (shares for a corporation or units for an LLC - limited liability company), the company is still adding equity to the total outstanding amount and therefore both create equal dilution on a per-share basis. This emphasizes the importance of understanding, at any given time, which of the two – cash or equity – has more intrinsic value to the collective existing ownership of the enterprise. Keep in mind, the dilution of managements ownership is not a one-way downward slide, as many advisors will tell you. Later in this article we will discuss how management can legitimately increase their ownership percentage in the company, without buying more. For the benefit of simplicity, this article will specifically reference the details involving corporations – regardless of the state in which they are incorporated. However, in most cases these details and approaches can be tailored to apply to most LLCs as well.

All this said, why is equity such a good incentive? It is well known that most people do not work for money alone. Most tend to seek jobs that offer job satisfaction, advancement and perks. A job at an early-stage company can be very gratifying. Advancement is of course very likely, especially when you get in early. As for perks, what sounds better than the prospect of a material cash payment somewhere down the road? If an individual can afford to work for a reduced salary, or even works for a full market salary, the idea of placing a bet of their time and energy on the future, can be very motivating. Isn't this a big part of what motivates entrepreneurs themselves? Others, feel similarly, just perhaps to a slightly lesser degree. That said, going back almost to the start of 'business', people have worked for a share of the profits. Working for equity is just another variation.

Role of the Board of Directors

As a long-time professional board member and board consultant, I often suspect that my bias may be to magnify the importance of a board and its authority. However, time and again we read stories and hear anecdotes from colleagues about situations where a board has made a decision or taken an action that either dramatically increased the value of the company, or alternatively, caused its downfall. Underestimating a board's relevance, even in an early-stage company, is a serious mistake, frequently made by entrepreneurs and even their *experienced* advisors.

The foundational documents (see more below) of any company will stipulate how all decisions are made on behalf of the enterprise. In a sole proprietor business, it is of course the owner who ultimately makes the decisions. However, in a corporation, in almost all cases, the foundational documents give that authority to the board of directors (the "board"). Of course, in a closely held firm, the board may consist of only the founder/owner, or perhaps it also includes a co-founder, spouse, or trusted associate, effectively still placing ultimate control with the founder(s)/owner(s). Regardless, they are still officially the board. Having board members who are experienced in the areas of raising capital, equity distribution, compensation, etc. can not only save the company tremendous amounts of money and trouble, but it can also be a meaningful strategic advantage.

Foundational Documents

Whether a company is initially incorporated by an attorney, or the entrepreneur themself online, the foundational documents have a critical long-term importance. Often, poorly conceived examples must be amended – sometimes more than once, to accommodate some unforeseen situation. If this only requires a resolution, that may not be a big problem. But, if the document requires filing with the SEC, IRS or State Secretary, or the company has enough shareholders that a shareholder vote is required, it can often become complicated.

Certificate of Incorporation

The initial document filed to incorporate is a **Certificate of Incorporation**, or Certificate of Formation, or sometimes, Articles of Incorporation ("**COI**"). This is filed with the Secretary of State of the state in which a company is formed. This need not be the state in which the company is actually located. There can be many factors in selecting the best state. These include convenience, cost, taxes, regulatory burden, case law, and more. Usually, entrepreneurs do not know why they choose a particular corporate structure. While taxes and fees can often drive the choice, in my experience it should actually boil down to the longer-term objectives of the company. If the goal is to create a large enterprise, to do business nationally, and to raise outside capital – particularly from individuals living outside your state or institutional investors, then typically the States of Delaware or Nevada are the leading choices. Taxes and fees are reasonable, but the solid body of established and universally understood corporate case law tends to make everyone more comfortable.

At minimum a COI requires the name of the company, the address of a registered company office in the state (almost always outsourced for a small fee), the purpose of the company, the name and address of the person incorporating the company, and the number of shares initially authorized, and the par (or starting/current) value of the shares. Documents containing only this minimum information almost always require amending and restating (additional filing) down the road.

Additional items, that can and often should be included, are reference to the board (perhaps naming the initial ones) and its authority, reference to the company bylaws (putting most required company authorizations in the bylaws is good practice), indemnification of directors and officers, certain voting requirements, and depending on certain longer-term objectives, perhaps reference to multiple classes of stock.

Bylaws

The second important document is the company **bylaws**. The bylaws are the core guidelines of a corporation. They determine how the corporation runs on a day-to-day basis.

Here is a simple way to remember the differences between the bylaws and the ***articles of incorporation*** **[COI]**. *If you think of a corporation as a picture, with a frame, the frame represents the articles of incorporation and the actual picture represents the bylaws. So, the articles of incorporation set the framework for the corporation, while the bylaws are the actual picture of what really happens.*

Bylaws are also private documents that are not filed with any government agency, while the articles of incorporation are public documents that must be filed with the state agency where the corporation becomes incorporated (e.g., with the state's secretary of state). As such, articles of incorporation actually cost money to file with the state, while the bylaws are free to create (assuming you do not pay a lawyer to create them for you).[2]

While most incorporators use off-the-shelf boilerplate COIs and bylaws, this is not best practice. The more inclusive they are of protections and controls, the better. Years later, when facing a crisis, or opportunity – like being taken over by an outside majority investor or selling the company – it is often too late to make key changes to the foundational document that allow you to proactively deal with the situation. The COI and bylaws both provide a wide variety of details on the parameters for operating the company. However, they should allow for a great deal of latitude in many of the specifics. For example, the bylaws might set the size of the board as up to seven without setting the specific initial number or electing them; or it might set out definitions of several executive positions that are not initially occupied; or it will define the specifics of board meetings and shareholder meetings, but not actually set any.

Organizational Consent

The third key incorporation document is the Organizational Written Consent ("**Organizational Consent**"). This instrument is actually the start of a line of documents that will be produced over the life of the company. It details any particular actions that the board wishes to take on day one, as the company begins operations. These directions can include the election of board members, the appointment of officers, instructions to establish an office or a bank account, and much more. This overall collection of items includes the minutes from meetings of the board, shareholders meetings, Board committee meetings, etc. They serve as a record of the rulings and directions of the board pertaining to the ongoing operation of the firm, and the working instructions to the company management.

Written Consents are internal documents that are often used by directors in a corporation, or members or managers in a limited liability company (LLC), to grant consent to a decision or action, in writing. ... A written consent typically takes the place of meeting minutes in order to record a final decision.[3]

While it is important to record various details and discussions, it is not required that this be in a great deal of detail. However, the key part of all of this collection are any resolutions. These are specific and mandatory decisions and instructions to management. Resolutions made and voted on in a meeting would be recorded in the minutes. Resolutions made without a specific meeting would be written consents.

Equity Distribution Techniques

An employee owning equity in a large well-established public company, usually simply considers it as part of their pay – albeit deferred. In a big company it is usually dispersed on a standardized regularly scheduled basis. The amount is normally determined by things like the level of employment, tenure, and performance, and is fairly uniform across employment categories. It is typically in the form of stock options ("**Option**"), but it also comes in several other forms. Equity incentives can be structured and offered in much the same ways by an LLC, although it can be much more complicated.

It is slightly different in an early-stage venture. There are new and evolving guidelines and metrics and strategies for allocating incentive equity to individuals. On day-one, there is nothing to guide the process. Once the company begins, hopefully guided by some experienced professional advice, the standards, goals and processes begin to be more established and consistent.

Equity Incentive Plan

The vehicle most frequently used by corporations to distribute equity to employees and other contributors is commonly termed an Equity Incentive Plan ("**EIP**"), or simply stock option plan. These plans represent a significant document - generally twenty to thirty pages. They all follow very similar guidelines and formats.

When properly constructed they adhere to specific IRS regulations that allow for the more favorable tax treatment of any eventually recognized gains that the individual may get whenever they actually sell the underlying stock.

The adoption of an EIP almost always requires approval of the board. The adoption of such a plan then allows the board to allocate a certain amount of company stock to a pool within the EIP. Then as management assesses its alternatives for compensating individuals, it submits their names and amounts to the board for approval. This submission normally goes to the board's compensation committee, if one has been established. The requested stock or option grants include details in addition to the number of shares, including strike price, vesting schedule, term, and exercise period. At the time the board approves these grants, it sets the shares' fair market value ("**FMV**"). Once approved, the grants – whether options, RSUs, restricted stock, or other – are documented by management. The documents are then sent to the grant/award recipients. These documents include a copy of the EIP, a grant notice (informing the awardee of the specifics of their grant), and perhaps a Shareholders Agreement and an IRS Form 83(b) [more later], which the individual must sign and return.

Stock Options

Options are the most common type of equity compensation granted by companies to their employees and executives. Rather than granting actual shares of stock directly, the company grants an option to buy a share, at some later date, at a price per share ("**strike price**") that must be set by the board at the current FMV of the share - in a private firm the board sets the price. In a publicly traded company, the price is the actual stock market price and the end of the day the grant is awarded. Clearly, on the grant date the option is worth nothing – since your strike price is the same as the value at that time. However, everyone hopes that over time the FMV of the shares will increase, even to the point of an IPO (initial public offering). At that time vested options can be exercised – at the original strike price – and then sold at the higher market price.

Here are the key considerations. (a) If these options are for an early-stage private company, even if the option were 'exercised' and the share was purchased, there is usually no market – no one who will buy the share. There

Incentive Stock Options

Incentive stock options (ISOs) qualify for special tax treatment under the Internal Revenue Code and are not subject to Social Security, Medicare, or withholding taxes. However, to qualify they must meet rigid criteria under the tax code. ISOs can be granted only to employees, not to consultants or contractors. There is a $100,000 limit on the aggregate grant value of ISOs that may first become exercisable (i.e. vest) in any calendar year. Also, for an employee to retain the special ISO tax benefits after leaving the company, the ISOs must be exercised within three months after the date of employment termination. **ISO taxation is complex. You must understand how the alternative minimum tax can affect you.**

After you exercise ISOs, if you hold the acquired shares for more than two years from the date of grant and more than one year from the date of exercise, you incur favorable long-term capital gains tax (rather than ordinary income tax) on all appreciation over the exercise price. However, the paper gains on shares acquired from ISOs and held beyond the calendar year of exercise can subject you to the alternative minimum tax (AMT). This can be problematic if you are hit with the AMT on theoretical gains, but the company's stock price then plummets, leaving you with a big tax bill on income that has evaporated.[4]

will also likely be restrictions for selling anyway. (b) When options are awarded, there is normally a 'vesting' schedule. This means that your options become vested or exercisable over time.

Example: *A W-2 employee might be granted 3,600 common stock options, at a strike price of $0.15 each, and the award vests monthly over three years (there are also a variety of other vesting details). This means that each month 100 options vest and could be exercised – in which case at the end of month one, the employee might pay the company $15.00 and buy those 100 common shares.*

It is the norm that options are not actually exercised until the stock can be sold, however all grants have an exercise period that triggers when the employee quits or is terminated. These periods can vary from 30 days up to five years. The norm is usually 90 days. If the individual is an employee, and the options were granted under an IRS qualified plan, they are considered **incentive stock options (ISOs)**, which offer some tax benefits. If the individual is not an employee, for example a board director, contractor, advisor or consultant, companies usually grant **nonqualified stock options (NQSOs)**. A NQSO does not qualify for special favorable tax treatment under the US Internal Revenue Code.

Thus, the word *nonqualified* applies to the tax treatment (not to eligibility or any other consideration). For IRS purposes, the difference between the strike price and the eventual selling price of each share is taxed. If the options were exercised and the shares were held for a minimum of one year, the proceeds qualify for long-term capital gains. If the shares are held for less than one year, it is ordinary income.

With a NQSO the taxes are due for the calendar year in which the options are exercised, based on the difference between the strike price and the current FMV, and then taxed again when the shares are sold, for the balance of any gains that were not previously taxed. With an ISO, the option can be exercised with no tax due, and the full gain is then taxed when the shares are actually sold.

Example: *Your stock options have an exercise price of $10 per share. You exercise them when the price of your company stock is $12 per share. You have a $2 spread ($12 – $10) and thus $2 per share in ordinary income.*
Your company will withhold taxes—income tax, Social Security, and Medicare—when you exercise NQSOs.
When you sell the shares, whether immediately or after a holding period, your proceeds are taxed under the rules for capital gains and losses. You report the stock sale on Form 8949 and Schedule D of your IRS Form 1040 tax return.

As noted above, there are several key elements, or variations, to stock option grants. These should be clearly laid out when the grant is approved by the board and stated in the grant notice to the awardee. Of course, the number of shares, and the FMV strike price, as determined by the board, are required.

Next, there will be a defined vesting schedule – the time or conditions under which the options vest. Variations here may include straight time-based vesting – like monthly, quarterly or annual vesting, over a period of up to four or five years. Companies may also award grants with what is called a 'cliff.' This means that there is no vesting – for say six months or a year (e.g., an employee probation period), then after that period all the options that would have vested, are vested retroactively. There is also the actual term of the grant itself – usually defined by the EIP. After that period – often five to ten years, the EIP itself expires, and must be replaced by another.

Another very important term is the exercise period. This defines the amount of time the awardee has to 'exercise' their options and purchase the shares by paying the strike price to the company. If they fail to exercise within that time period, the options expire – gone. Why would this happen? Several reasons. For example: they forget (this does not usually happen if the exercise period is 30-days of even 90-days, but if it's longer, perhaps), of if at the end of the exercise period, if you cannot sell the stock, and cannot afford to pay the combined strike price or the taxes. Most commonly, the strike price is simply higher than the FMV – this is called being 'out-of-the-money' or underwater. Therefore, you would have to pay more for a share than it was worth at that time.

There is one more potentially important term called change-of-control. This provision stipulates that if there is a change in control ("**CoC**") of the company – usually defined as majority ownership shifting from one individual or organization to another, like if the company is sold, some percentage or perhaps all of the options automatically vest. For example, if one got a grant of 24,000 options, vesting monthly over two years (usually stated as 1/24th per month), and this grant has a 50% change of control provision, and the company is purchased by another ten months after the grant. These options would have been vesting at 1,000 per month. Ten months would have vested 10,000, leaving a balance of 14,000. A CoC of 50% would mean that 50%, or 7,000 of the 14,000 remaining options, would automatically be vested, for a total of 17,000. This provision is usually used to protect selected employees, and make sure they continue to contribute even if some liquidity event is on the near-term horizon.

Restricted Stock & Restricted Stock Units

While stock options are the most common type of equity compensation granted by companies to their employees and executives, other types of grants have meaningful advantages under certain circumstances, particularly to very early-stage and much later-stage organizations. Two of the most popular stock bonus structures today are the restricted stock unit ("**RSU**") and the restricted stock award ("**RSA**"). Let's compare and contrast to help you understand which is better when and why.

The primary difference between stock options, and RSAs and a RSUs, is that the latter two are not options. They are actual awards of stock, or the right to take possession of stock – not options to buy. The RS can be of particular value to a very early-stage venture that has not yet taken in any equity capital (promissory notes do not count here) or established an enterprise value that would require or encourage the board to set a FMV above the original par value of the shares, or some other minimal price. This allows the awarding of actual RS shares without triggering a significant tax obligation on the part of the recipient.

The RSU can be of particular value to a later stage company that has a relatively high established FMV per share price, where the award of actual shares would trigger a significant tax obligation on the part of the recipient.

Both are termed ‘restricted’ because while RSA shares are actually given, and RSU shares are actually promised, they both carry a condition, or restriction. This restriction is the right of the company to either buy any unvested RSA shares back upon the employee’s termination, or not actually deliver any unvested RSU shares should the employee be terminated or fail to meet other award conditions. In this context, the shares do not actually vest, but rather, their restrictions expire over the ‘vesting period’, or when the employee meets the award’s milestones.

Restricted Stock Units

RSUs are a promise made to an employee by an employer to grant a given number of shares of the company's stock to the employer. Generally, RSUs are granted based on a vesting schedule, meaning the employer must continue to work at the company for a specified period of time before the full value of the RSUs can be awarded. In some cases, particularly for higher ranking executives, RSUs can also be tied to performance goals either individually or at the corporate level, and they can also contain covenants that can terminate the RSUs if the employee is terminated for cause. Generally, an RSU represents stock, but in some cases an employee can elect to receive the cash value of the RSU in lieu of a stock award.

Once RSUs are exercised and become actual shares of the company's stock, those shares come with standard voting rights for the class of stock issued. However, before the RSUs are exercised they carry no voting rights. This makes sense because the RSUs are themselves not actually stock, and therefore don't carry the same rights inherent to the stock itself.

RSUs are taxed as ordinary income as of the date they become fully vested, using the fair market value of the shares on the date of vesting.[5]

Restricted Stock Awards

RSAs are similar to RSUs in many ways but have their own unique differences as well. Like RSUs, restricted stock awards are a way for the company to reward employees with stock in addition to their standard cash compensation. Restricted stock typically vests over time and can be subject to forfeiture if the employee is terminated, quits, or fails to meet any performance objectives as stipulated in the stock award program.

However, the similarities largely stop there. Restricted stock awards come with voting rights immediately because the employee actually owns the stock the moment the award is granted. This is in contrast to RSUs, which represent the right to stock, as opposed to owning the stock but with restrictions. Also, restricted stock awards cannot be redeemed for cash, as some RSUs can be.

The tax treatment of restricted stock awards comes down to a choice by the employee. The employee can pay taxes similarly to an RSU award, with the fair market value of the restricted stock counted as ordinary income on the day *of vesting. However, thanks to a rule called Section 83(b), restricted stock award holders can also elect to pay the ordinary income tax based on the fair market value of the stock on the day it is granted. This feature is beneficial to many highly compensated executives because it provides them with greater choice in their tax planning.*

Sometimes, restricted stock awards require that the employee pay a certain amount in order to accept the restricted stock. In essence, the employee is paying for the shares, typically at a discount. This structure can reduce the tax burden for the employee because the taxes paid on the restricted stock award will be based on the difference between the value and the amount the employee paid, instead of the total value of the stock.

For employees without lower incomes, this requirement can be a major issue with restricted stock awards. This is part of the reason why with many companies, the use of RSAs, and RSUs have gained popularity in recent years, especially with firms with higher share values.

While similar in most regards, the differences between RSUs and restricted stock awards can have a major impact on how valuable a stock bonus can be. It's critical to consult with an accountant who has experience with various stock award structures to ensure you maximize the value of your RSUs or restricted stock based on your own personal situation.[5]

IRS Form 83(b)

It is important to remind people that when they actually get something of value, the Internal Revenue Service wants its share – typically on the April 15th following the end of the year in which the gain was realized. Whereas, with stock options no value is received by the awardee until they exercise the options, pay the strike price, and take possession of the shares. Note the description of ISOs and NQSOs above. And, in the case of an RSU, similarly the recipient does not take possession of the shares until all the conditions have been met. However, in the case of RSAs, the actual ownership of the shares of stock are transferred to the individual – albeit with the condition that the company has the 'right', but not the obligation, to buy it back, on some pre-determined terms, if the full term or conditions are not met. Shares awarded with an RSA have the full rights of their class – e.g., voting, dividends, etc. Since this means that the person has received value, that value is taxable as there is value. If on the award date the stock had a par value of say $0.001 or $0.01, then for that year a person receiving 1,000 RSAs would owe tax on $1.00 or $10.00 as ordinary income. Then, each and every year after that, the person would owe tax on the increasing value of those shares. If they failed to meet the conditions of the award, and do not receive some of the shares, there are no tax refunds. In order to help citizens avoid the inconvenience of reporting these annual increases in income, the IRS has provided an exemption. The taxpayer may complete a Form 83(b) and submit it to the IRS. It is a very brief form that simply details the terms of the grant. With this form now on file, the IRS waives the necessity of annual taxes on the increasing value of the award and postpones any further taxes on this until the shares are sold. At that time the taxpayer reports the difference between the original value stated on the 83(b) – which they previously paid the tax on, and the selling price. Caution: an individual only has thirty days from the date of the award to file the form. Many have missed this detail and subjected themselves to a lot of unnecessary tax-filing headaches. As always, check with your accountant, CPA or financial advisor for advice regarding your specific circumstances.

Stock Classes

Most working people have heard the terms common stock and preferred stock. What do these mean? Beware, I have seen some very misleading definitions of these terms. Today, governance and equity have evolved to the point that these two terms mean basically whatever the board wants them to mean. Historically, common shares were the most basic ones – one vote, and a pro-rata share of the net proceeds of any distribution. Also, historically, preferred shares were those that had special provisions attached. While these provisions were normally positive, they need not be. Therefore, in today's world of finance, governance, and corporate equities, the board usually defines the meaning of these terms, unless precluded so by the certificate of formation preempting them. Today you will see some preferred shares with no voting rights, and some that have 100 votes per share (termed super-voting rights), you will also see some common shares with no voting rights, and others with super voting. Many venture investments yield preferred shares with a liquidity preference. In this case, upon a liquidity event, these shares get a designated return or payout, before any other shares receive their pro-rata share. You may also see either with special voting rights that give just a particular class the right to approve or disapprove certain actions. When evaluating transaction agreements be sure to understand the difference between pro-rata and pari-passu.[6]

A company may issue multiple versions of each class of stock, e.g., ‘Founders’ common, regular common, Common B, Preferred A, B, etc. The issuance of each specific and different offering of shares is termed a ‘series’, e.g., Series A, B, etc. Early series consisting of only common may be termed Seed Series.

Most frequently, awards or grants under a company EIP will be common stock (but can still be voting or non-voting). Preferred shares are usually reserved for investors, particularly those demanding certain concessions in exchange for their investment – e.g., a liquidity preference, a seat on the Board, interest on their investment, etc. It can be very important how you allocate these types of special provisions to investors. This is a very complex area of finance and governance. A sensible move is to engage an expert early in the company’s life cycle to understand these variations and take a proactive approach to giving the founders, owners and senior management the maximum flexibility is defining and using these variations.

Raising Capital

Second only to the founding of a company, and sometimes later surpassing it, raising capital normally has the most dramatic effect on the distribution of equity. It is not uncommon for a founder of a start-up to own 100% of the issued shares. If there are multiple founders than they have split this up somehow so combined they own 100%. In the eyes and experience of most entrepreneurs, there soon starts an irreversible and sometimes disturbing downward trend in their ownership percentage. It may frequently lead to the founders' loss of control of the company. It may even eventually lead to the founder(s) being ousted from their own company – although usually by that time it is actually no longer 'their' company. Yes,

Refer back to the anecdote: The right advice at the right time – or missing advice (page 12)

[See the section below on Protecting Founder Control.]

there are many good investors out there, and yes, there are numerous cases when the founders' keep (and sometimes even lost and regained) control for a long time after taking in outside capital – Bezos, Gates, Jobs, Ellison, Dell, Zuckerberg, Yang, Dorsey, Musk, Son, Ma, Page/Brin, and others. However, as notable as this list is, these are exceptions, unless they remain completely private and take in a minimum of outside funding.

As we previously noted, equity is primarily distributed for founding an enterprise, contributing to one, and investing in one. Let's talk about raising capital from investors. This is a very big subject, and the topic of many good books, and endless advice from everyone you know – attorneys, investment bankers, other entrepreneurs, venture capitalists, your senior advisors, your junior colleagues, and even guys or gals at the gym.

We will not address here any of the technicalities or strategies for raising early-stage capital. As noted above, there are plenty of books on that. However, it is worthwhile to at least list the most common variety of funding options in vogue today.

- Friends & Family: they just write you a check and with a handshake say, "we'll figure it out later"

- Straight sale of equity (Seed or otherwise): involving a term sheet, stock purchase agreement, shareholder's agreement, SEC Regulation D filing, SEC Rule 506 exemption, etc.
- Loan: Promissory Note
- Convertible vehicle: Convertible Promissory Note, Simple Agreement for Future Equity (SAFE)[7]

There are any number of strategies and reasons to use one of these tools or many other less-well-known structures. These are the most common, but far from a comprehensive list. And each one has dozens and dozens of variables, options, opportunities, pitfalls, clever workarounds, and potentially ridiculous bone-headed choices to be made. This document does not go there. What follows is some important information that is generally not well-known; or is frequently misunderstood, ignored, or improperly applied.

Determining Valuation

In 2000 I founded a full-service incubator and a venture capital firm, raised capital, and started investing in technology start-ups (ultimately about 40). One day during a meeting with an entrepreneur I asked what he was seeking for a pre-money valuation. Without hesitation he said $2.5 million. I asked him how he arrived at that. He confidently responded, "The Berkus Method.[8]" I said, what? He said, it's something published by someone at Harvard. Well, I had been in the business for a long time, even at that point, and I had only ever met two guys named Berkus, and they were brothers. I asked the entrepreneur if it had anything at all to do with a 'Dave

Berkus'? He said he had no idea, except the method was published by Harvard.

If Exists:	*Add to Company Value up to:*
Sound Idea *(basic value)*	$1/2 million
Prototype *(reducing technology risk)*	$1/2 million
Quality Management Team *(reducing execution risk)*	$1/2 million
Strategic relationships *(reducing market risk)*	$1/2 million
Product Rollout or Sales *(reducing production risk)*	$1/2 million

When I checked into it, sure enough it was my old friend Dave, who I had done business with in the 1970s. The attraction of the method is very simple – each of five milestones is awarded up to $1/2 million, depending on your subjective level of achieving that objective. Full accomplishment thereby would yield $2.5 million.

While this overly simple approach may help serve as one element in testing the validity of a valuation, few investors will really give it much credibility. It is simply not nuanced enough for any experienced ones. Each of the five components needs to be broken down and measured fairly objectively. The most effective way to gage a more accurate pre-money valuation, or the FMV, is actually direct 'comps' – comparable numbers and metrics from other companies as closely related to yours as possible in the areas of products/services, market size, stage of product development, funding history, comparable management team, number of users, number of paying customers, total revenue, profit (if any), and more. Keep in mind that the ultimate arbitrar of the value of your enterprise is the investor or buyer. This is the most reliable way of gaging an investor's or buyer's appetite.

Beyond comps there are a variety of other metrics including some multiple (1X, 2X…10X) of trailing (looking back over time) revenue and or EBTIDA (profit), leading (looking forward over time) revenue or profit. The multiple usually depends on the current transaction environment and normally varies by industry and sector.

One interesting exercise that I like to encourage is the following: It is almost certain that an investor would buy your company for $1.00, assuming at least that there are no liabilities. In the same vein, it is unlikely that one would pay $1 billion for it. The idea is that the right price – for investment or sale, lies someplace in between. The closer that the number an investor is willing to pay, is to the number that you are willing to accept, the more likely at deal – obviously.

The point here is, if it's your company, or you are CEO, or simply own controlling interest, the price at which you are willing to accept investment capital or sell the company, is set by you, with board approval if necessary. Certainly, current opportunities or difficulties may weigh your decision on valuation either up or down, but it still remains yours. Now that must coincide with what the investor is willing to pay. That is where art and science meet – setting your valuation and then justifying it with the firm's exciting accomplishments and prospects, and some quantifiable quasi-standard metrics.

Valuation Methodology

There are two kinds of information that goes into the valuation of an early-stage company – or any company for that matter – anecdotal and numerical.

Anecdotal	**Numerical**
Exciting Idea & Story	Number of Users*
Huge Market	Number of Paying Users*
Fantastic Product/Service	Gross Revenue*
Stage of Company & Product	Profit*
World-class Management Team	Actual Growth Rate
Poorly Positioned Competition	Financial Projections
Requires Modest Capital	Assets* & Liabilities
Tremendous Net Margins	Headcount
And More…	And More…

Anecdotal details are a combination of fact and vision. Successful delivery of these messages depends on their veracity and the skill and charisma of the deliverer of the message. A good story creates the motivation for the investor to be interested at all. Without connecting on this, it's unlikely that any investor would even care to hear the numbers.

In terms of numbers, the only ones that all early-stage companies do well on are … expenses. Unfortunately, the investor expects that, but is not interested. It does not help the valuation narrative. To be perfectly clear, many companies have raised money with few or no actual numbers.

His Net Worth and more…

In 1994 an entrepreneur named David Bohnett, and his co-founder John Rezner, started a company named Beverly Hills Internet. They soon rebranded the company as GeoPages, and then finally changed its name again to GeoCities.

By 1999 GeoCities was the third most visited site on the web and was purchased by Yahoo for about $4B. At that time, David's ownership percentage had been diluted to about five percent.

In 2000, at a venture conference, David said, "I started GeoCities by charging 150% of my entire net worth on my VISA card." Still, a pretty good for six years of work.

However, for the most part, if an entrepreneur is starting their first venture, even if they have a decent track record of working for other companies, and they are lacking extensive connections, or they don't normally associate with discretionary wealth, they will need to do it the hard way – bootstrap. That means scraping together some money and some colleagues and just starting. As mentioned above, the easiest and usually first money available is *friends and family* – called that for obvious reasons. If one can use those seed funds to prove out the business concept and hopefully even generate some actual numbers, then the opportunity to raise additional capital becomes more achievable.

Explaining the Common Metrics

We have previously mentioned various versions of valuation metrics used in investment or acquisition transactions. They all represent somewhat standardized formulas based on a company's financial performance or projections, and they are accepted in their basic form by various buyers in various industries. Usually, the metrics are multiplied by certain multipliers to arrive at general valuations that fall into ranges that have meaning to buyers and investors in that particular industry or category – e.g., computers, communications, enterprise software, software-as-a-service, retail, agriculture, medical practices, insurance brokers, and so on. Each industry has its favorite metrics, and the multiples are usually relevant to the current economic times – how popular that industry is with investors at the moment. In the stock market, a primary metric is the price-earnings ratio for a company. Stock buyers look at those PE ratios, as they are called, and compare and companies based on that. While earnings are an important component of valuation for a going concern, it is much less relevant when the company has no earnings. But, why would someone invest in a company with no earnings?

An early-stage company typically has a long-term strategy that focuses on growing the company and increasing the value of the enterprise. In this way it can provide a return to its shareholders and investors – on paper. In order for those shareholders to convert the paper gains to cash there must be some type of liquidity. Liquidity for investors comes in three primary forms:

- Distributions: paying out dividends to shareholders in the form of cash
- Acquisition: selling all or part of the company to another firm, and distributing the cash and stock proceeds to the shareholders
- Initial Public Offering (IPO): becoming a publicly traded entity by virtue of listing the company directly on an exchange (OTC, NASDAQ, NYSE, etc.), or merging into or acquiring a shell company

that is already publicly traded (whether a reverse merger, or acquisition by a SPAC special purpose acquisition corporation that is already public), which will ultimately allow the shareholders to get liquidity by actually selling their shares in the market

Companies that have the goal of staying private will eventually begin distributing their profits – after retaining enough in the company to continue to grow. Many firms are founded with the strategy of growing and positioning the organization for an ultimate sale or IPO. When growth – in customers, revenue, and valuation – is the goal, the firm will rarely make a profit because it is re-investing all its revenues back into growing the business. This is why, particularly in younger, faster growing concerns, they rarely show a profit. In fact, their strategy will likely even require that they continue to raise additional capital to feed more rapid growth, at the expense of earnings. Not having earnings (profits) therefore, is not necessarily a sign of not having value. In this case, the value is then normally measured on the *potential* for profits and future growth. What metrics are used for this?

By eliminating earnings (profit) from inclusion in a calculable metric, you are primarily left with revenue, however, there are others. A controversial one is 'eyeballs' – the number of people accessing the application or platform on a daily, monthly, annual basis, their usage patterns, their churn/retention measures, their number of clicks or downloads - mostly their potential for monetization. [See 'Go Figure!' below.]

Most frequently when using revenue alone as your metric, it is always a multiple of annual revenue, but it is important whether you are looking back at previous numbers, or forward at projected numbers. Some common approaches are, a multiple of:

- The revenue from the previous year, or *trailing year*.
- The revenue from the latest month x 12, or *leading year*.
- The revenue projected by the company for the next 12 months, or *projected annual*.

The application of the multiplier to this annual revenue figure will vary widely, as we have noted, by sector, industry, category, business model, geography, and other criteria.

In one case, for example, an insurance agency may be valued at a price of one times their total commissions on policies (their revenue) for the past 12 months (trailing year). Yet in the case of a cutting-edge enterprise SaaS (cloud-based software-as-a-service) application, the value could be set at 10 times the revenue they are projecting over the next 12 months. (projected year).

Go Figure!

Is it easier to generate revenue dollars, or downloads and clicks?

A few years ago, I read something in the WSJ that said, "When the product is free, YOU are the product." How times change. With what I know now, one only needs to start a company that generates non-paying 'users' (notice we do not call them customers) to achieve a sky-high valuation.
In 1985 I founded a company called **Ducommun Data Systems**. From the day I opened the door it shipped and invoiced real customers for $22,000,000 in computers, in the first 12 months in business. At that time the company was conservatively valued at about $25M, or about 6X trailing earnings.

Today, a company that generates 22,000,000 free downloads in its first 12 months could easily be valued at $1B – perhaps 40-50X more than my 1985 venture.

Anecdote: In mid-2013, Facebook reportedly offered to buy Snapchat, an upstart messaging app at that time, for $3 billion. Later in the same week that news came out I was in a board of directors meeting of an early-stage social media company in Dallas. We were having a discussion about granting stock options to some young interns that were helping the company. The discussion settled on a $1,000,000 company valuation as being Fair Market Value (FMV) at that time, for the purpose of setting the strike price on the options. I said, "let me just check one possible comp." I asked the CEO how many followers our company had on Facebook and Twitter combined. I divided our $1,000,000 FMV number, by the total number of followers, and arrived at a per-follower value. Then, just for fun, I divided the $3B Snapchat offer (valuation) by the number of downloads they had most recently reported. All of our faces turned pale. Both of the resulting numbers were the same - to five decimal places. I assure you, it was just a strange coincidence, but "Go figure!"

Calculating Share Pricing

For some reason, many people consider this exercise to be very complicated, and often make costly mistakes. I will try to simplify this as much as possible.

In early-stage deals, investors may simply put in their money, and get whatever you give them. However, it's naïve to expect that; so be prepared. So, here is the sample problem to be solved. Hopefully going through this will help clarify and value the various elements of the equation and give us some insight into fairly and successfully navigating this in real life.

You have established the pre-money valuation of the company at $2.5 million. Your investor has indicated that they are willing to invest $500,000. How much of the company do they own, as a percentage, (a) 20% or (b) 16.667%? Believe it or not many entrepreneurs have gotten this wrong.

Calculation: Pre-money valuation = $2,500,000, Add in the newly invested $500,000 for a post-money valuation of $3,000,000 ($2.5M + $500K = $3M). Therefore, $500,000/$3,000,000 = .16667

That sounds simple, but there is more. How many shares do they get? The three founders collectively own 180,000 shares. Does the investor get (a) 30,006 or (b) 36,000?

Calculation: $2,500,000/180,00 = $13.8889/per share. $500,000/$13.8888 = 36,000

So far this is very straight forward. However, what happens frequently is this:

1. Founders: founders shares (3 @ 60,000 ea.) = 180,000 shares
2. Employees: stock options totaling (2 @ 1,500 ea.) = 3,000 stock options (vesting 1/24th mo., 1/3

vested today) Note: 36,000 shares in original option pool.

3. Board Members: restricted stock (2 @ 3,500 ea.) = 7,000 restricted shares

Now, what is the share price for the investor, and how many shares does their investment purchase? Actually, this cannot be answered with the above information alone. There is a missing variable, the exact number of shares used in the calculation, which will then be divided into the amount of the investment, thus yielding the price per share. The number of shares necessary for this calculation is generated by the mutual parties, the company and the investor, agreeing on the definition of a key concept – *dilution*.

Dilution occurs when a company issues new shares that result in a decrease in existing stockholders' ownership percentage of that company. Stock dilution can also occur when holders of stock options, such as company employees, or holders of other optionable securities exercise their options. When the number of shares outstanding increases, each existing stockholder owns a smaller, or diluted, percentage of the company, making each share less valuable.[9]

How could there be any debate or negotiations involving the number of shares? Isn't that a very clear number? Well, in a word, no. There are several common classifications of shares for the purpose of this calculation.

- Outstanding share: those actually issued by the company with no restrictions

- Restricted share: those actually issued by the company, but with some restrictions
- Stock option: option to buy a share in the future, under specific terms
- Restricted Share Units: promise to issue a share in the future, under specific terms
- Warrant: option to buy a share in the future, under specific terms (only slightly different than an option

Here is the most important concept to grasp relative to this exercise – the more shares that are counted, when divided into the agreed upon valuation, the lower the share price. The lower the share price, the more shares the investor gets for their money.

Using the numbers from the example above:

a. *Counting just the 180,000 founders' shares, the share price is $13.8888, and the investor gets 36,000 shares.*
b. *Adding the restricted shares that the board members have, yields 187,000 shares, and the investor gets 37,400 shares.*
c. *Adding all the stock options granted, yields 190,000 shares, and the investor gets 38,000 shares.*
d. *And finally, adding all the options in the EIP stock option pool, yields 223,000 (187,000 from b above, plus 36,000 from the note in #2 in the example), and the investor gets 44,600 shares.*

There are two terms normally used to reference this. The first is 'outstanding shares', while this would normally mean just the shares actually issued (a), it should *technically also include the restricted shares on an as-if-fully-vested-basis. The second term is 'fully-diluted'. This reference can include whatever anyone wants it to. The entrepreneur may wish to leave it as just including the issued and restricted shares – thereby assuming that they will all fully vest. On the other hand, the investor (usually an institutional one) will press for full dilution to include a + b + c + d +the remainder of unissued options in the pool + all outstanding warrants. This should give you a good idea why it is very important that you have a seasoned expert at your side before you enter into this type of negotiation.*

This example clearly shows that which classes or types of shares are counted in the number used for determining the per share price, based on an agreed upon pre-money valuation, has a big impact on the dilution suffered by the founders, employees and any previous investors. Entrepreneurs beware, negotiating this with a new investor can be a very delicate process, but extremely important to both sides.

Tip: one of the things that often gets early-stage entrepreneurs into trouble is talking in percentages. When you are discussing ownership in a venture, of course your ownership can always be measured as a percentage. However, there are two problems with using a percentage as the metric for discussion, (a) stating ownership as a percentage is misleading, since it can be different depending on which share model is used (as we just discussed above), and (b) an ownership percentage number – e.g., "you own 20%", will stick in someone's mind, and a short time later, when there has been some dilution, they may be disappointed to learn that they no longer own 20% - this is a psychological phenomenon, not a mathematical one. [This can be an even bigger problem with an LLC. Denoting ownership as a percentage can incur unnecessary conversations and expenses. In order to bring in additional capital, or issue ownership to anyone new, it will most often require a re-write of the LLC's Operating Agreement, which may require legal fees.]

What is the alternative? I always recommend stating ownership in terms of the number of shares or units someone owns. That number does not change (unless of course they later acquire more ownership). With a corporation, ownership is automatically stated in terms of share numbers. In an LLC, for some reason many attorneys (especially ones that I would not recommend) like to articulate ownership in percentages. I always recommend converting ownership to units as early in the company formation process as possible. Knowing the number of units they own, an individual can always convert their number into a percentage – one simply must know and understand what comprises the total they are using for the calculation.

As a reminder, this is yet another reason to form a fiduciary board, or at minimum an advisory board early-on, comprised of a variety of seasoned experts in various areas that complement and augment, your own experience, not duplicate it.

Protecting Founders

This section addresses information that is seldom talked about, except after the fact, when a founder has been 'thrown out' of the company they started. I never read about this anywhere, and the warnings and entrepreneur may get usually come from someone who has suffered the consequences of not educating themselves adequately in advance, for instance, "Don't ever take an investment from a venture capitalist, they will end up stealing your company." That is ridiculous, no VC wants to take over a company. They invest, they do not make their money operating. For every rejected founder that gives that advice, you can re-wind their history back to the day they sat at a table, across from the VC. That's the day the VC passed a final investment agreement across the table to the founder, and he or she… signed it. Whose fault was that? Who signed the agreement that gave the power to the VC allowing them to exile the founder? The solution is being educated in advance. Understanding the elements of a transaction, and the governance and ownership rights that it establishes. Having experienced, seasoned advisors – like board members – who have done numerous deals like yours and learned the lessons the hard way and have the scars to prove it. Why not let their experience save you from making many of the same mistakes that may have taught them?

That said, what's the deal?

1. Founder(s) incorporate the company.
2. Founder(s) adopt Certificate of Incorporation and Bylaws.
3. Founder(s) elect initial board of Directors.
4. Under the originating documents, certain actions can be taken with a vote of the board, while other actions require a vote of the shareholders. Generally, these votes require a simple majority, but in some specific cases they may have been

created to require a super-majority (more than 50%, e.g., 66.67%).

5. At some point shareholders grow to include investors and others who are granted stock
6. Usually for some period of time the founder(s) control over 50% of the shares, perhaps even 66.67%, but as additional capital is raised, the founders' share will likely drop to below 50%, thereby technically losing control.

From here it can get very complicated. A great deal depends on not only the percentage ownership of the 'insiders' (founders and close allies), but also who is on the board. Remember, in the beginning certain decisions were left to the board (like hiring or firing the CEO) and others require shareholder approval – either a majority or super-majority (like authorizing an increase in the number of company shares, and also electing the Board itself).

In addition to the very specific and detailed provisions in the foundational documents themselves, the next key consideration defining control is specifically who is on the board, and how will they vote. Unless the sins of a founder are egregious, or the actions they propose are really bad, a board that they elected will usually vote in their favor. However, if board members are elected (adding to the board or replacing other directors), the composition of the board changes. At some point and investor (e.g., a VC) may collectively have more votes than founders. These are the circumstances that can allow the overthrow of a founder. There are two techniques for preventing, or at least impeding this.

Special Voting Preferences

We have just touched on super-majority voting approval requirements. The reciprocal of that is super voting rights. Most everyone who follows leading technology companies these days are likely aware of the discussion about the number of votes that *founder's shares* have, as opposed to other or 'common' shares.

Some examples or super voting shares[10]:

- Alphabet (parent company of Google), 3 stock classes (A class = 1 vote, **B class = 10 votes**, C class = no voting).
- Berkshire Hathaway, A class = 1 vote, **B class = 1/10,000 vote**s.
- Coca Cola Bottling Co, A class = 1 vote, **B class = 10 vote**s.
- Dell Technologies, **A class = 10 votes, B class = 10 votes**, C class = 1 vote, D class = 1 vote.
- Facebook, A class = 1 vote, **B class = 10 vote**s.
- Lyft, A class = 1 vote, **B class = 20 vote**s.
- Slack Technologies, A class = 1 vote, **B class = 10 votes, Sunsets in 2029 (no super voting shares after 2029).**
- Snap, A class = no votes, B class = 1 vote, **C class = 10 votes**.
- The New York Times Company, A class = elect 30% of the board, **B class = elect 70% of the board**.

There are some lessons here. In each case the company has taken certain steps to protect founders and insiders by using super voting rights. This list does not tell us who owns which class, e.g., the founders, the board, early investors, later investors, or the public shareholders. However, some of these details are known. For example, there has been a great deal of controversy over the fact that the founder of Snap owns C class, while ALL the public shareholders own A class. It is also well known that only the original founders and perhaps some original employees of Alphabet/Google and Facebook own the B class shares. However, I did not previously know that Berkshire Hathaway had B class shares of that magnitude. I wonder who owns those?

Another lesson is that there is no one size fits all, there are many different approaches and option for crafting control provisions. The New York Times uses its voting preferences to weight the board.

The example of the New York Times demonstrates a very basic version of a technique that is much more subtle than super voting rights. It is generally termed *class voting rights*. In this case, while shares in a certain class may have only one vote, the class as a whole – all the votes in that class, collectively have certain rights. In the case of the Times, clearly those holders of B class – whether this is one person, a family, or includes others, controls the election of a super-majority of the board. Effectively being able to approve or block anything that the minority of board directors might want to do.

Without divulging too much *secret sauce* here, let me note that by creating and awarding certain class voting rights to insiders, the company can very effectively protect their rights over most major actions – like ousting the founders. This ladies and gentlemen is much less blatant and offensive as one share having a single vote, and another having 10. Some very observant individuals may point out that new investors may not like provisions like this. No problem. If these protections are not there, the founders have missed a very valuable method of protecting their interests. Protection that may well save their company. However, if protections like this are imbedded in the governance structure of the company before they come on the scene, and the investors note them and object, they will deal with them by insisting that the company remove these rights before they invest their money. This can be easily done – since the founders have the special rights in the first place. However, it presents the opportunity to negotiate the terms for removing the rights. Perhaps the investor increases the valuation, perhaps they invest more money, or perhaps they settle for fewer board seats. If the founders want the investment, they can negotiate something mutually acceptable.

One important point to note is that provisions like these should not be added shortly before the investment round. The earlier in the company evolution the better. For one thing, at the beginning is when the founders have the maximum control and can add such things without discussion.

Another important point again goes back to the board itself. Most institutional investors understand the power of the board and will want to weight it in their favor if they can. If an entrepreneur thinks that they will be fine adding board members when they have investors that want the seats, they are dead wrong. A VC’s favorite start-up board is the founder, and two VCs. It is strongly advised to create your board as early on as you can, certainly before bringing on investors. Then grow it with directors that can add tremendous value, not your buddies. Fill it out as completely as you can – a total of 5, 7, even 9 is advisable. Then when you have an investor that wants a board seat, they are joining a well-established, and founder-friendly board, rather than dominating it.

Additional Insider Equity Grants

Another tool for protecting founders relates to their compensation. It is extremely common that after someone starts their company, and even puts in their own money, they – and often a number of colleagues – will work for no compensation (salary or stock) for some period of time, usually quite a while. In most cases this is not accounted for officially in any way. The justification in their mind, and supported by others, is that they own a large piece of the company, so make it worth something. Let's say that this continues for a year or so, and the company is up and running. It has raised some capital, launched its product, added more employees, and perhaps even has customers and possibly revenue. Humor me here for a moment. The founder now just walks out the door and plant themselves on a beach somewhere. Question: Do they own a single share less of the company than they did on the last day they worked? No. However, back at the company, the other owners of the company, the investors and management, must now recruit a new person to lead the firm. Whoever that person is, they are unlikely to be willing to work for the same salary the founder was – zero dollars. Whether they pay the new leader a market salary with equity, or much less. It is guaranteed that it will be more than the founder was making. Now consider this concept. The founder got their equity for starting the operation. Anyone that works there, including them should get some form of compensation for their efforts. Yet entrepreneurs regularly initially work for long period of time without any pay. The point here is that they should be putting modest compensation on the books, for themselves and other contributors. A new CEO of a tech startup may get up to $250K in salary, and perhaps an additional 5-10% equity in the company. That would be somewhat unreasonable for the founder, however, they could accrue $75K or $100K in salary and be awarded an additional 1-2-3% in equity. Similar arrangements can be made for loans. These amounts accrue on the books. In the future, when there are investors scrutinizing the books for a possible investment, or the company is flush with cash, there will be a time to deal with these accrued amounts. At any time, the board can award these things, and at any time the board can determine their resolution. Perhaps the cash is paid out, or some or all of it gets converted to additional equity. This is not only fair, but is an additional element of minimizing the dilution of ownership that insiders often suffer.

Additional equity awards, in the forms of restricted stock or options, should be awarded to key contributors. In theory, everyone, including the founder, should have unvested equity in play as a continuing carrot out there – golden handcuffs, so-to-speak. Again, this is another element to help counter the natural dilution caused as companies advance in their evolution.

Conclusion

Hopefully this piece gives aspiring entrepreneurs some valuable information. As many topics and as much detail as is included above, it only scratches the surface. Everyday thousands of dreams are launched by entrepreneurs in the form of a *company*. Most of these individuals have no idea of what they are stepping into. Few seek advisors whose advice is up to the job. They embark on this journey knowing a fraction of what they need to know to increase the odds of their vision turning into a monetizable reality, and even less about how to retain their rights as founders, to continue to define its direction. For every Zuckerberg, Dell, Bezos, Gates, Ellison, and Buffett, there are hundreds of disillusioned, disappointed, and failed entrepreneurs who were not able to ride their dream to success.

Entrepreneurs don't be left behind. Acknowledge what you don't know. Learn it whenever and wherever you can. Get world-class colleagues and advisors. Surround yourself with talent and experience in the form of a great board of directors. Persist and lead your team. Best wishes.

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[1] The number of authorized shares of a corporation is set in the Certificate of Incorporation (or Formation). Any change must typically be approved by a majority vote of shareholders. One common mistake is setting the authorized number too low to accommodate future needs including raising capital and incentive equity grants to contributors.

[2] LegalFlip.com: Introduction, Purpose of Bylaws

[3] Google: definition

[4] MyStockOptions

[5] Motley Fool Staff

[6] Robinhood

[7] Y Combinator

[8] The Berkus Method

[9] Investopedia.com

[10] My Financial Wealth.com

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