§1 Introduction

One of the most common, and important, issues for new companies during the start-up stage is establishing the initial capital structure for the company (i.e., determining the number and type of equity securities to be issued to the founders and reserved for issuance to other employees and outside investors). While the founders typically perform most, if not all, of the work relating to the business following formation of the company it is the rare situation where the founders have sufficient funds to support the company all the way through to the point where cash is being generated from the sale of products and services. Accordingly, funding of some sort will be needed from various outside sources that may be looking to receive equity securities of the company. In addition, the founders should expect that it will be necessary to issue shares, or options to purchase shares, in order to recruit other employees with the skills and background that the company needs in order to be successful.

When setting the capital structure the founders must wrestle with several difficult decisions—the allocation of ownership interests among the members of the founding group; how much equity to give up in order to attract seed capital from non-professional investors (i.e., relatives and friends); what programs should be established for bringing in new employees, including non-founder senior executives, as owners of the business; and how to plan for raising substantial amounts from venture capitalists and other professional investors to finance rapid expansion of the business. In addition, consideration must be given to placing restrictions on transfers of ownership interests and establishing procedures for repurchasing ownership interest from departing founders and employees so that the interests can be used to recruit replacements and skilled persons to fill other positions. The discussion below assumes that the company has been formed and organized as a US corporation and that capital will be raised from venture capitalists and other professional investors.

§2 Common and preferred shares

In general, the “typical” capital structure for emerging companies that are likely to be raising capital from venture capitalists and other professional investors will include both common and “convertible” preferred shares—the common shares will be issued to the founders and other employees under some form of stock purchase or option program and the preferred shares will be set aside for issuance to outside investors when the company is ready and able to raise significant amounts of working capital. Common and preferred shares carry very different legal and economic rights and the two-tiered capital structure is used to provide the incentives of an ownership stake to the founders and the members of the employee group, most of whom will be asked to accept salary and benefit packages that are less than those offered by established companies, while giving outside investors...
important protections that will usually remain in place unless and until the company is sold or the preferred shares are converted into common shares upon completion of the company’s initial public offering.

As the name implies, *preferred* shares have a superior legal claim to the assets and earnings of the company as long as they are outstanding. This is true when the business is going well since the preferred shareholders will typically have the right to receive distributions in the form of dividends up to a specified amount before dividends can be paid to the common shareholders; however, it is even more important when the company is in financial difficulty since common shareholders will not be entitled to any liquidating distribution until the preferred shareholders, as well as the non-shareholder creditors of the company, have been fully repaid. In addition, outside investors in an emerging company that are purchasing preferred shares will demand and receive special class or series voting rights that give them effective control over all major decisions relating to the company’s business even though the preferred shares on an “as converted” basis would be outnumbered by the common shares owned by the founders. Founders are nonetheless willing to accept some of the potential disadvantages associated with issuing preferred shares to investors in exchange for the tax advantages explained above that all of the shareholders may be able to enjoy through the careful use of two classes of stock.

§3 Authorized, issued and reserved shares

The articles or certificate of incorporation will specify the total number of shares of each class—common and preferred—that are set aside, or authorized, for issuance at any one time. Prior to issuance the terms and conditions of the preferred shares will not be specified and will be left for later determination by the board of directors. The preferred shares are often referred to as “blank check preferred” since the directors are effectively given a “blank check” to create one or more series of preferred shares (e.g., Series A Preferred) to satisfy the requirements of investors at the time the shares are issued without the need for shareholder approval of amendments to the articles or certificate of incorporation unless required under the terms of an outstanding class of preferred shares. Merely authorizing preferred shares does not disqualify the corporation from electing Subchapter S status for tax purposes as long as the shares are not issued and sends a signal to outside investors that the founders have planned in advance for the two-tier capital structure normally associated with an emerging company. As such, the founders can still enjoy the benefits of Subchapter S status during the initial phase of operations leading up to the point where outside investors will be recruited.

The number of authorized shares at the time the company is formed is actually somewhat arbitrary and can be changed in the future by vote of directors and shareholders; however, an effort should be made at the time of formation to authorize a sufficient number of shares to meet the foreseeable needs of the company through the point where it is ready to complete an IPO. With respect to the preferred shares this means authorizing a sufficient number to complete all of the anticipated rounds of financing from outside investors at the projected pricing levels, which are determined by the projected market value of the business at the time that the round is undertaken. With respect to the
common shares this means authorizing a sufficient number to satisfy several different constituencies and requirements—the issuance of large blocks of shares to the founders and other key non-founder managers and employees; the establishment of employee stock purchase and/or option plans that include enough shares to keep up with recruiting needs through the IPO; the issuance of shares to investors upon conversion of their preferred shares, presumably on a “one-for-one” basis; and the issuance of shares to the holders of other types of convertible instruments (e.g., warrants and convertible debt securities) including financial advisors, lenders, consultants and strategic business partners. Common shares may also be issued to parties that do not fall within the groups mentioned above including shares issued to “friends and family” to raise small amounts of start-up capital until the first round of venture capital financing can be completed and shares issued to lawyers, accountants and other professionals in exchange for services performed in connection with the formation of the company; however, the amounts should not be substantial and should be issued on terms that do not impede the ability of the company to attract funding from venture capitalists and other professional investors.

As the description above implies, the capital structure of an emerging company is much more complex than just the number of common and preferred shares that may be issued and outstanding on the records of the company at any point in time. In fact, there are two measures that are commonly referred to and which must be carefully understood by the founders and non-founder senior executives when they are dealing with outside investors. First, they need to know the number of “issued and outstanding shares of common stock on an ‘as-converted’ basis,” which is the sum of the number of shares of common stock that are actually issued and outstanding plus the number of shares of common stock that would be issued and outstanding if the holders of all of the currently outstanding convertible securities (including the convertible preferred stock) elected to exercise all of their conversion rights. Second, they need to know the number of “issued and outstanding shares of common stock on an ‘as-converted, fully-diluted’ basis, which begins with the issued and outstanding shares of common on an as-converted basis computed above and adds to the number of shares that would be issued and outstanding if all of the options and warrants that have been granted and are currently exercisable were indeed exercised in exchange for common shares.

The various factors to be considered in establishing the initial capital structure for an emerging company will be explained in the sections that follow using an illustration based on the reasonable assumption that the founders and their counsel have decided to authorize 30,000,000 shares at the beginning and break them up into 20,000,000 common shares and 10,000,000 shares of “blank check” preferred stock. For the sake of simplicity we will also assume a fairly straight-forward equity planning scenario without special circumstances such as the need to issue shares to friends and relatives to raise money to keep the company going until the founders can gather support from venture capitalists. This means that we can focus on how the capital structure will come into play when issuing shares to the founders, recruiting other senior executives and key employees who may need a significant equity stake in order to come aboard, establishing an equity incentive program for other employees and, finally, raising large amounts of money from venture capitalists and other professional investors to finance development and
commercialization of products and technology and expansion of the company to meet increased demand.

§4 Issuance of initial common shares to founders

The creation of the initial capital structure begins with the issuance of common shares to the members of the founder group. The actual number of shares is not that important since the real issue will ultimately be the percentage of the total issued and outstanding shares of common stock on an as-converted, fully-diluted basis that has been allocated to each of the key shareholder groups—the founders, other employees, and outside investors—at any point in time. The main purpose is to give the founders an ownership stake in the plans they have formulated for their new business and the time and effort they will be expected to invest in order to make it successful and profitable (i.e., “sweat equity”). The allocation of shares within the founder group depends on factors that must be considered and addressed on a case-by-case basis. While the founder shares could be allocated equally it is more common to attempt to consider the relative contributions that each person has made, or is anticipated to make, to the formation and successful launch of the business taken into account the factors discussed above.

Following the illustration introduced above, we could reasonably assume that 2,000,000 common shares will be issued to the members of the founder group and distributed in accordance with the principals discussed in the previous paragraph. In determining the “purchase price” for these shares reference should be made to achieving certain tax advantages associated with being able to issue common shares to the founders and other employees who will provide services in exchange for receiving an equity interest and preferred shares to the investors who will be providing cash in order to fund the operations of the business. Founders and employees want a low value assigned to their shares so that they will not have a substantial tax liability when the shares are issued. On the other hand, the investors want a high tax basis for their shares as long as they are still paying fair value for the equity interests they receive in exchange for their capital contributions. The parties are able to achieve their respective goals by issuing the common shares to the founders and other initial employees at a deep discount in relation to the price that the investors will pay for their preferred shares. This practice can be justified, or at least explained, by the fact that the preferences with respect to liquidating distributions and dividends given to the preferred shares amount to a material subordination of the economic rights associated with the common shares for so long as the preferred shares are outstanding and conversion or redemption of the preferred shares is not imminent (i.e., an IPO, which triggers automatic conversion of the preferred shares into common shares, is not anticipated in the near future).

It is not uncommon for the price per share of the common stock issued to the founders to be 1/10 of the price per share of the first series of preferred shares issued to the investors even though the preferred shares are convertible one-for-one into common shares (e.g., the founders pay $0.10 per share for the common stock and the investors pay $1.00 per share for the preferred stock). While the founders often pay cash it is not surprising to find that some or all of the shares may be issued in consideration of services performed
for the new company rather than an actual cash investment. If we assuming that 2,000,000 common shares are being issued to the founders, and that the purchase price for such shares will be set at $0.10 per share, the total consideration, in cash or in-kind, for the founder shares would be $200,000. While this is not a small amount it generally is not enough to sustain development of the business and the founders expect and hope that investors will supply the necessary capital soon after the company has been launched and the common shares have been issued. Perhaps the most important thing about “2,000,000” and “$0.10” is how those numbers factor into determining the number of preferred shares to be issued to the investors and their per share price.

§5 Issuance of preferred shares to initial outside investors

Venture capitalists and other professional investors like the $0.10/$1.00 ratio between the price of the founders’ shares and the first series of preferred shares issued by the company (i.e., “Series A Preferred Stock”) because it reflects the appropriate tax-related discount discussed above and it makes it fairly easy to set the initial capital structure of the company. Through negotiations between the founders and the investors agreement is reached on three key issues—what is the “pre-money” valuation of the company, which is the value assigned by the investors to the participation of the founders and the tangible and intangible assets and resources they have already made available to the company in exchange for their 2,000,000 common shares; how much cash will the investors contribute to the company and what percentage interest in the equity of the company will they receive in return; and how many authorized but yet to be issued common shares will be set aside (i.e., “reserved”) for use in recruiting additional executives, managers and other key employees.

Determining the pre-money valuation is both an art and a science and depends on a myriad of factors as well as the negotiating skills of the parties. In many cases the investors will establish the valuation, and therefore the price, that will apply to the offering; however, the founders should make an effort to level the playing field by coming up with their own valuation based on objective and verifiable assumptions regarding markets, competition and the amount of capital the company will need to get the next stage of development. One common valuation method uses discounted cash flows over three to five years. The amount of cash raised in the first round will depend on the business plan developed by the founders and the activities that the company proposes to undertake one the investment made and up through the time that a second round of funding is expected. If possible, the founders would prefer to minimize the amount of capital that the company takes in at a lower valuation to avoid substantial dilution to their ownership interest; however, this is a risky strategy if it turns out that the amount of money actually raised is not enough to get the company to the point where it can demonstrate a real increase in the value of the business and the company runs into trouble just as a crucial “window of opportunity” for the company to gain an advantage with respect to its products and services is about to close. As for the pool of common shares reserved for further issuance, the general rule of thumb at the time of the first round is to establish a pool of shares equal to 10%-20% of the issued and outstanding shares of common stock on an ‘as-converted’ basis immediately following completion of
the preferred stock financing; however, the actual percentage will depend on the needs of
the company and it may be necessary to set aside large blocks of shares (i.e., 1%-5%) to
fill key executive positions that cannot be staffed from within the founder group.

In order to show how the initial capital structure is created let us assume, once again, that
the founders are issued 2,000,000 common shares at $0.10 per share and that negotiations
between the founders and the investors lead to the following understandings—the “pre-
money” valuation of the business is deemed to be $3 million; the investors will put in $2
million for a 40% stake in the company; and an employee stock pool of 20% will be
established immediately following the closing of the financing. In that case, if we wish
to peg the price per share for the Series A Preferred Stock at $1.00 the investors would be
issued 2,000,000 shares and the employee stock pool would be 1,000,000 common
shares. On a percentage basis the capital structure would be 40% for the founders, 40%
for the investors and 20% reserved for future employee issuances. One obvious, and
important, assumption here that the founders need to understand is that the shares
reserved for future issuance to employees, while not yet outstanding, are factored in “pre-
money” and thus dilute the ownership interest of the founder group.

§6 Guidelines for issuance of common shares reserved for employees

When addressing the issues described above with respect to the initial capital structure
the founders, as well as the investors, need to establish guidelines relating to the issuance
of shares pursuant to the employee stock purchase or option plan. The first rule should
be that equity incentives should be reserved for executives, managers and key functional
employees rather than being dispersed throughout the company and down to the level of
administrative staffers. In fact, the founders should be able to create a budget for the
employee stock pool that covers all of the anticipated personnel needs for the company
up to the time that it is anticipated that the company will need to go out and raise
additional funds. The budget should be based on market conditions and thus track what
similar companies might be willing to offer to qualified candidates. Second, shares and
options should be treated as “sweat equity,” rather than irrevocable signing bonuses, and
it is therefore important for the company to impose vesting restrictions to ensure that the
employees remain with the company for a substantial period of time. In fact, it is typical
to provide that shares and options will vest in increments over a four-year period.
However, founders should also expect that a large portion of the common shares already
issued to them will also be made subject to vesting under the terms of a stock restriction
agreement that they will be required to sign as a condition to closing of the first
investment round.

§7 Handling obligations to “friends and family” investors

While the illustration above has been kept simple, it should come as no surprise to find
that before the investors provide their commitment to a substantial round of financing the
company has collected cash for operating purposes from the founders in the form of loans
and from friends and relatives of the founders in exchange for common shares and/or
company promissory notes (perhaps guaranteed by the founders). Taking on a lot of debt
has its own risks including the possibility that the loans will be re-characterized as equity for tax purposes and the potential loss of the corporate liability shield. More importantly, however, is that the investors will want these transactions “cleaned up” before proceeding—they don’t want a debt owed to the founders have a liquidity preference over the preferred shares and they don’t want a lot of small shareholders who are in a position to influence the founders. Accordingly, the founders should be prepared to renegotiate some of the deals that they made in the early days of the company including repayment of loans provided by friends and relatives and perhaps convincing small shareholders to accept a buyout for a modest premium over the amount that they were willing to invest to support the founders.
About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, *Business Transactions Solution*, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 80 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph.D. from the University of Cambridge. For more information about Alan and his activities, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

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