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PERSPECTIVE

Startups need to pay more attention to founder stock

By Murray A. Indick and Jonathan J. O'Connell

The good news is that exciting and disruptive startup companies continue to be formed on a daily basis. The better news is that companies continue to close financing rounds with unicorn ($1 billion-plus) valuations — and occasionally even early-stage businesses have an extraordinarily large M&A takeout generating front-page news coverage.

The bad news? Inadequate attention is paid by some startup businesses to important details — such as founder stock and seed investments — at the outset. These failures can lead to considerably greater legal and tax expense, adversely affect new employee hiring, and delay future venture capital financings.

In our view, common stock generally should be issued to founders at the time of incorporation. Relatedly, early investors generally should be issued preferred stock, convertible notes or other convertible instruments like the YCombinator SAFE — and not common stock. There is a surprising amount of confusion among even sophisticated players in this vibrant ecosystem. Getting it right at the earliest stage of the business is the prudent course of action

Founder Stock — Don't Delay Issuing Shares

Founders should keep in mind that equity issuances should always be priced at current fair market value in order to avoid creating tax problems. The value of the company will increase due to revenue, investment or other factors — and so will the value of the company's capital stock. If stock is issued below fair market value, then taxes on the "spread," i.e., the difference between the issue price and fair market value, will be incurred.

Startup companies should therefore issue founders common stock at or immediately after incorporation at a very low price (usually par value, which will likely be a fraction of a penny, e.g., $0.0001). The low price is justifiable because the company is newly formed and has no assets or revenue. If a founding team delays issuing shares until the time of a first financing event, it becomes difficult to argue the company is worth $0, as

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investors are paying a real price at this time). It is almost always prudent to issue shares as part of the "starter kit" when the company is formed.

Founders should also consider commissioning an independent valuation report, often referred to as a "409A valuation," when issuing equity awards to employees after incorporation, particularly after a financing event. The 409A valuation report will set forth the minimum exercise price for employee stock options and may be relied upon for a one-year period; provided that there are no intervening material events, like a financing event. 409A valuations are not inexpensive, but the benefit of being able to rely on the "safe harbor" provided by these valuation reports far outweighs the cost of such reports. Ultimately, all equity awards need to be priced at current fair market value and a valuation report will help a startup company identify the correct price per share of its common stock at a particular point in time.

Does a Common Stock Investment make Sense?

Many early investors believe they should receive common stock in return for their seed capital. But, as a general matter, that would be a mistake.

Selling common stock to investors will assign an enterprise valuation to the company. For example, if a startup agrees to sell 10 percent of the company, in the form of common stock, to an outside investor in exchange for $100,000 then the company will be worth $1 million after the investment closes. Assuming there are 10 million shares outstanding after this investment closes, then the fair market value of a single share of common stock is now $1. Subsequent common stock issuances will be difficult to justify at a price per share below $1 if the startup business is performing well.

In the event a startup needs to bring on a new cofounder or if equity awards will be used to attract and motivate employees, as is often the case in the Bay Area, the new hires will be stuck with a high share price. We have seen potential new employees reject a company's offer of employment when the perceived equity upside (from a dramatically higher strike price) seemed to be limited. Many startups, particularly those not working with counsel, do not realize that the high share price is an issue until it is too late.

Instead, it will often make sense to issue convertible notes or other convertible securities, like SAFEs. This will avoid a discussion around enterprise valuation at the earliest stage of a company's life and preserve the company's ability to motivate new hires with a lower equity award price.

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