

Take Stock When Using Stock In Trade

Part 1: Stock Basics

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STARTING UP: *Practical Advice for Entrepreneurs*

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Take Stock When Using Stock In Trade Part 1: Stock Basics

Last week the two founders of a MIT spin-off software company (which I will call Thunderbolt Software) came in to see me about issuing stock to their initial employees. Thunderbolt had just received a \$500,000 check as the first installment of the OEM deal which Thunderbolt had inked with a major software company. This major accomplishment for Thunderbolt was in no small part a result of the endless hours spent in software code development by the two Founders and their two initial employees who had received only minimal cash compensation. With the major hurdle of the OEM deal accomplished and cash in the bank account, the two Founders were finally ready to turn to issuing the stock they had promised to the two initial employees. Now comes the fun part.

Thunderbolt Software was incorporated as a Massachusetts corporation with 275,000 shares of Common Stock authorized, which is the maximum number of shares which can be authorized for the \$275 incorporation filing fee which has to be paid to The Commonwealth of Massachusetts. The two Founders, who I will call Bill Kapor and Mitch Gates, had on paper divided the 200,000 shares into three main components: The 50,000 shares which had already been issued to the two Founders (a total of 100,000 shares); 50,000 shares would be for employees and 50,000 shares would be for investors. Following this mental model Bill and Mitch promised each of the two initial employees 4% of the stock. When they arrived in my office Mitch said "Joe, please issue each of these two employees stock certificates for 8,000 shares - 4% of 200,000 shares. Next we have a question about software escrow agreements...."

"Hold it", I said. "The two initial employees will each own about 6.9% of Thunderbolt or 13.8% together. After I issue 8,000 to each of them there will be a total of 116,000 shares outstanding - your 100,000 plus their 16,000. Bill, 8,000 divided by 116,000 is 6.9% not 4%." There was a moment of silence. "But what about the 200,000 shares?", asked Bill. Here is the story.

The 200,000 shares constitute the "Authorized Shares". This is the maximum number of shares that Thunderbolt Software can issue under its Articles of Organization or charter. This number can be increased if the stockholders amend the charter, file the amendment with the state and pay a filing fee. The Board of Directors votes to issue shares from this Authorized pool. Shares which have been issued and are still in the hands of stockholders are called "Issued and Outstanding" shares. If shares have been issued and subsequently repurchased or reacquired by the corporation they are called "Treasury Shares"- they have been issued but are no longer "outstanding".

Some numbers will illustrate these terms: Assume that Thunderbolt initially had three Founders, each of whom had been issued 50,000 shares. One Founder leaves and forfeits all of her shares. These forfeited shares and any shares the company repurchases are called "Treasury Shares".

Authorized Shares:	275,000	
Minus Issued:	<u>150,000</u>	150,000
Authorized and Unissued	125,000	
Treasury Shares		50,000
Issued and Outstanding		100,000

It is the number of "Issued and Outstanding" shares which counts from an economic viewpoint. If Bill and Mitch had issued 1 share to each of them then the Issued and Outstanding shares would be two shares and each of them would own half of Thunderbolt Software (1 of 2 shares). In addition only the Issued and Outstanding shares have a vote. Note: In the above example, the number of shares which can be sold/given to others is 175,000, which equals the Authorized and Unissued (125,000) plus the Treasury Shares (50,000).

What Bill and Mitch did was to promise their two initial employees 8,000 shares based on all of the Authorized Shares. This would have resulted in each employee owning 4% if in fact all of the Authorized Shares were issued and outstanding. The fact of the matter is that Bill and Mitch don't know whether exactly 200,000 shares will be issued in the future. Perhaps they will do other OEM deals and not need outside investors. Perhaps the outside investors will demand more than 50,000 shares, perhaps they will settle for less.

Here are some suggestions in talking about stock with employees:

Are you sure that stock "motivates"? Stock provides a longer term return. Not all employees will value stock the same way. For example, salespeople should "live for the sale" and as such are generally short term focused, which is generally what you want.

Do employees really understand the technical aspects of stock? The Founders, didn't. Why should they expect their employees to be any more knowledgeable? Try this test: Which would you rather have: 100 shares or 10,000 shares? Answer: you have to tell me how many shares are issued and outstanding - 100 shares might represent 50% of the company whereas 10,000 shares could constitute less than 1%. However, many persons would place a higher value on 10,000 shares because it sounds like more.

How much stock should I issue to employees in general? This is really a matter of philosophy, corporate culture and market conditions. We are all victims of our past experience. The past experience of the Founders in other companies will tend to shape their approach to stock in the new venture. For example, I have seen Founders who want a broad ownership of stock simply because in a past job they saw the negative impact of too large a concentration in the hands of a few people. There are some metrics however. For example, historically in many first round venture capital deals 12% to 18% of the stock is reserved for employee stock grants /options going forward. The amount of stock issued to employees varies by industry. Talk to others and check out current industry statistics. Most of the major accounting firms publish compensation surveys by industry. For example, I often consult the Biotech Compensation Survey put out by PricewaterhouseCoopers.

Finally, make sure you understand the technical aspects of stock before you make commitments. Bill and Mitch wish they had. So "Take Stock" when using "Stock in Trade" for services. In a future column we will discuss approaches to setting specific stock allocations with employees.

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