Start Ups and Emerging Companies – 101: Shares and Shareholders

by Derek A. Ridgway

A Corporation (as opposed to an LLC) is owned by its shareholders. A Corporation may have one or more shareholders. Shares may be purchased by a person or another company. If a company is the sole or majority shareholder in another Corporation, the company is considered to be the "parent" company of the Corporation.

A person becomes a shareholder when he or she (or it) is issued shares in the Corporation. Shares must be issued for consideration. The consideration may take the form of cash, property or past services. Cash or property exchanged as consideration for the shares may be used to capitalize the company. Shares in a Corporation may not be issued in exchange for future services.

When a Corporation is formed, the Articles of Incorporation provide for how many shares the Corporation is "authorized" to issue. "Issued" shares are those shares held by the shareholders. It is perfectly acceptable for a Corporation to authorize, for example, ten million shares, but only "issue" 100 shares. The owner(s) of the 100 shares issued by the company would, in this example, own 100% of the Corporation, despite the fact that the Corporation is authorized to issue another 9,999,900 shares when it so chooses. As an owner of shares, the shareholder owns "equity" or "ownership" in the company, which is sometimes referred to as an Equity Position.

The Articles of Incorporation of the Corporation may authorize common shares, or may authorize common shares and one or more classes of preferred shares (aka, "Preferred Stock"). Preferred Stock receives certain preferences that are not available to the common share stockholders, such as preferred rights to dividends, distributions, voting privileges, liquidation preferences and anti-dilution rights. Preferred Stock is generally reserved for enticing Private Equity investors to invest in the company when operating funds are needed to bring the company to the next level.

When a company is formed, stock is typically issued to the founders as a matter of course. This is usually documented in the company's Organizational Minutes. Thereafter, stock issuances are documented by a Stock Purchase Agreement, Subscription Agreement or Share Warrant. In any case, it is important that all stock issues be property documented. Failure to adequately document the Corporation's actions may result in the Corporation losing its limited liability protections. Stock must also be registered before it may be issued, unless an exemption to the securities laws applies.

A shareholder should also consider the tax implications of receiving shares in a company, including the implications of IRC 83(b).

Example how founders might set up their business

100M Dream Company

In the above example, 5 founders form a company and after Series A and Series B Private Equity funding, each own $6,000,000 in a 100M company. As a general rule of thumb, after funding, 50% of the company is owned by Private Equity investors, 30% of the company is owned by the Founders, and 20% is owned by the talent (in Restricted Stock and Stock Options).

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