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Stock issuance: how is it done and what is required?

Now that you have formed a corporation, one of the first formal corporate actions that will be taken is the issuance of stock to the founders. That stock issuance usually happens as part of the corporate formation process, but a corporation issues stock and other securities throughout its life cycle. Ensuring that a corporation's securities (like its stock, options and warrants) are properly issued and documented is essential for good corporate housekeeping, which will allow diligence by prospective investors or acquirers to proceed smoothly. This article explains the basic requirements to keep in mind when your corporation issues any securities.

When is board approval required?

Board approval, either by written consent or at a board meeting (for more about the differences between board consents and board meetings, please see our article), is required for every issuance of a security, whether that security is common stock, preferred stock, a warrant, an option or a note that is convertible into some type of stock. Securities are not validly issued without the approval of the company's board of directors. Ratifying and cleaning up the company's capitalization records can be a long and costly process, so ensuring the securities are validly approved by the board of directors at the time of issuance is a simple step that will help avoid headaches and unnecessary costs down the line.

Does the company get paid?

The security must always be "duly paid" for, which means the company must receive something of value for the security. Payment may be monetary (cash, check or agreeing for forego repayment of a debt owed by the company) or property (giving property, such as equipment, technology or intellectual property rights) or services (which must have already been provided – *ie*, a promise to provide services in the future is not considered an acceptable form of payment). There are often tax issues to be considered when looking at different ways to pay for stock, which can vary based on the security holder's individual tax situation; it is always a good idea to consult with a tax attorney or accountant to avoid unintended tax consequences. For example, issuing stock to an individual as payment for past services typically results in the individual having to recognize and be taxed on the value of that stock as ordinary income.

What documents are needed?

The documentation required for issuance of securities differs depending on the type of security. If the security is stock, then the documentation would include board approval and a fully executed stock purchase agreement. If the security issued is a stock option, the documentation would include board approval, an independent third-party valuation (highly recommended), a copy of the stock plan, an option grant and a fully executed option grant notice. If the security is preferred stock as part of a venture capital financing, the documentation will include board approval and a stock purchase agreement, as well as a suite of ancillary agreements (including a stockholder consent) that together are probably more paper than any first-time entrepreneur would ever expect.

The key here is to ensure that you have all the typical and required documentation signed, maintained securely and accessible – in turn forming the basis for a smooth due diligence process in a financing or sale of the company (for more about due diligence, please see our article).

What is a securities filing?

The issuance of every security, no matter how large or small in quantity or value, must comply with state and federal securities laws. Those laws require that the company take certain steps to provide prospective investors full disclosure about the company and the risks of the investment. Where a company is offering only a small amount of securities to a discrete number of prospective investors, or where the prospective investors are already aware of the risks of the investment (because they are already involved with the company as officers, or directors, for example), or the law has determined that they are able to bear the risk of the investment (because they have experience with similar types of investments or have a high net worth or high income level), a company may be able to rely on "exemptions" and not make the otherwise required, and sometimes extensive and time-consuming, disclosures. Whether an exemption may be available to a company or not, a document may need to be filed in order for the company to comply with the applicable state or federal securities laws. This is another matter that is routinely diligenced by prospective investors and acquirers of a company. Therefore, it is important to consult with an attorney to be sure that your company is compliant.

Certificates: paper or electronic?

While public companies haven't issued actual certificates for stock for years, private companies have only recently started using "electronic" certificates. It is not difficult for a company to use electronic certificates, but there are certain steps a company must take in order for that use to comport with legal requirements. For more about the use of electronic certificates, please see our article.
