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Tips for raising venture capital: stockholder and equity issues

By Jeff Lehrer

Prospective investors will always want to know who owns the company they are about to finance. This article outlines common stockholder/equity issues that all startup founders should know when positioning themselves to raise venture capital.

Before starting the process, **familiarize yourself with VC term sheets**, including liquidation preferences, veto rights, anti-dilution protection, pay-to-play provisions, dividends, redemption and preemptive rights. Refer to an article that goes into more detail about these terms, and for an overview of the differences between authorized shares, outstanding shares and reserved shares.

Pay special attention to board composition. Consider the potential impact of strategic investors, customers or ex-employees having seats on your company's board. Refer to our article for tips on your initial board composition and for information on initial officers and roles.

Making sure that each issuance of stock (including stock options) is **properly authorized at the time of issuance** will help you avoid future headaches and even the possible loss of thousands of dollars. For more information about who gets what in the world of stock option grants, refer to our article. See our article for an overview of granting options vs. issuing restricted stock.

Similarly, make sure to properly **paper founder stock ownership**; otherwise, the founder risks potential forfeiture of all or a portion of such stock should he or she leave the company. Refer to our articles for information about founder shareholders agreements, for founder stock allocation and vesting, and for founder stock alternatives.

Carefully consider stockholder rights. From the founder's perspective, it may be advantageous to have stockholders subject to a drag-along provision or IPO lock-up provision. Also, consider restricting transfer by existing stockholders and implementing a right of first R\refusal (RoFR) in favor of the company. Along the same vein, avoid stockholder agreements with unanimous amendment provisions or overly broad stockholder veto rights.

Don't overpromise. A common example is granting preemptive rights or rights to participate in future financings – an obligation that may end up being difficult to uphold. Another example is issuing or otherwise promising to issue non-dilutable equity ownership to stockholders. Similarly, prioritize your company's growth by avoiding the issuance of fully vested stock to employees and founders, despite a promise of future performance.
