Authorized shares vs. outstanding shares vs. reserved shares: what are they? How many to authorize? And why?

The value of a corporation is reflected in its stock, and it is the goal of every budding entrepreneur to make his or her corporation, and the stock in the corporation, worth something. A corporation also uses its stock as an incentive to attract talented individuals who can help build the value of the corporation. In addition, stock can be a currency for buying assets, such as intellectual property, that add value to the corporation's portfolio.

Therefore, having the right number of shares of stock available for the corporation's use is critical to ongoing operations. In this article, we identify a few basic legal concepts and business considerations that may be helpful for entrepreneurs who are seeking to understand whether their corporations have the right number of shares.

What are authorized shares?

Authorized shares are the number of shares specified in a corporation's charter as the maximum number of shares the corporation may legally issue. In the beginning, when a startup's charter is filed, the number of authorized shares must, at a minimum, account for the shares to be issued to founders, the shares to be reserved for issuance under any stock option plan and any additional securities to be issued or promised by the startup in the near future.

Determining the appropriate number of authorized shares depends on several factors. Angel investors and venture capitalists often prefer a startup to issue between 10 and 20 million shares of common stock at the outset. Of those authorized shares, generally, around eight to nine million shares might be issued to the founders, with an additional one to two million shares reserved for the employee stock option pool. One reason the preferred approach is to authorize millions of shares for issuance at the outset is that it provides a startup with the flexibility to issue smaller percentages to employees, advisors and contractors without having to deal with issuing fractional shares, since often an employee, for example, may only receive a tiny fractional percentage ownership (typically, less than 1 percent) of a startup.

The remaining authorized but unissued shares are available in the event a corporation needs to issue more shares. These additional authorized shares, held in reserve, give a corporation some flexibility in the event that it depletes the initial amount of shares reserved for the employee stock option pool and needs to increase the pool when hiring a new employee, co-founder or executive. If a startup does not have a cushion of authorized shares beyond the number of already issued shares, it would first need to deal with the administrative burden of obtaining required board and stockholder approvals to increase the number of authorized shares of common stock, and then would need to file a charter amendment in its state of incorporation.

See our article about how shares are issued to founders.

What are outstanding shares?

Outstanding shares are shares of stock that a corporation has issued and which have been "fully paid for." Each state requires that each share of stock be fully paid for in order to be considered properly issued and "outstanding." Payment may be in the form of cash, check, past (not future) services, a promissory note, forgiveness of a debt the corporation owes or transferring ownership of property (either tangible physical property, like a computer, or intangible property, such as a copyright in the software code).

What are reserved shares?

Reserved shares are authorized shares that are set aside for issuance in the future. Shares are often reserved for issuance under a stock option plan. These reserved shares are part of the total number of authorized shares, but the corporation may not issue them, except underthe stock option plan. See our article about determining how many shares to reserve in a stock option plan.

Authorized shares are also reserved when the corporation issues a warrant to a third party to purchase stock. If such warrant holder exercises the warrant, the corporation then needs to have enough shares reserved to issue to the warrant holder.

Once the corporation raises money by issuing preferred stock, a certain number of authorized shares must be reserved for the conversion of the preferred stock into common stock.
