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Founder friendly stock alternatives II: getting liquidity and Class FF preferred

By Jonathan Axelrad

Many successful founders find themselves in the difficult position of being stock rich and cash poor, which can be especially troublesome when living in high-cost tech centers like the San Francisco Bay Area, New York, Boston and Los Angeles. Founders who plan ahead, however, may be able to use Class FF Preferred Stock to get some early liquidity.

Class FF Preferred Stock

FF Preferred Stock is essentially common stock with a twist that allows it to be converted to preferred stock. Issued to a founder, it typically can only be converted to the round of preferred stock being sold at the time of a new financing and upon approval of the board. It can always be converted at the option of the founder into common stock. Class FF Preferred is used by founders to get some early liquidity. Once the stock is converted to preferred, the founder then to sells that preferred stock to new or existing investors in the company. FF Preferred Stock should be adopted at formation and represent only a small portion of the founder's stock because, for tax purposes, the stock needs to be granted fully vested. We typically recommend no more than 10 to 25 percent of the overall equity allocated to a founder be Class FF.

Class FF has yet to see widespread use, but it does accomplish some valuable things should investors be comfortable with allowing founders to take something off the table (you should be aware that views vary on this, and one needs to be sensitive to the message it sends to investors *ie,* you're not necessarily all in to win). In reality, founders' stock holdings probably represent a huge amount of their net worth, and a founder's salary may not be expected to be sufficient to support the founder and his family over the time it takes to grow a company into the unicorn that most investors desire.

Assuming your investors are on board, Class FF will allow a founder to sell what is essentially common stock and for an investor to buy preferred stock. Through this process, the total number of shares outstanding remains the same, because the founder is selling her own stock and the investor is buying that same stock once it's converted into preferred stock. Thus, because investors are not buying a newly authorized class of preferred stock, overall dilution is reduced. As an added benefit, using Class FF Preferred Stock will help avoid unnecessarily inflating the company's 409A price used to establish the exercise price of the company's stock options, helping to ensure the company's options remain an attractive tool to motivate the company's employees.

For more about stock options and determining the exercise price, please see our article.
