Capitalization Tables and Memorializing Your Capital Structure

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DEFINING SUCCESS TOGETHER

Introduction

- Goals for this Workshop
  - Provide an overview of a capitalization table for a corporation
  - Explore the dilutive effect of option awards and other equity issuances
  - Learn best practices for capitalization table management
  - Discuss how financing rounds and other events affect founders’ equity

Anatomy of a Cap Table

- A capitalization table sets forth all of the outstanding equity or ownership interests in a company, as well as all rights to acquire any additional equity interests, as of a fixed point in time.
  - Common Stock
    - Class A, Class B; voting vs. economics
  - Preferred Stock
    - "Common Stock Equivalent"
    - Series FF Preferred; Designer Equity
  - Options and Convertible Securities
    - Equity Incentive Plans
    - Convertible Debt
    - SAFE's
    - Warrants
  - Capitalization table vs. stock ledger

Fully-Diluted Capitalization

- The fully-diluted capitalization of a company is the total number of shares of the company's common stock that would be outstanding if all rights to acquire or convert any stock are exercised in full.
  - Assumes that all outstanding options and warrants are exercised in full.
  - Assumes that the company has issued the maximum number of options or shares reserved for issuance under the company's equity incentive plan.
  - Assumes that all outstanding shares of preferred stock are converted into common stock at the then-applicable conversion rate for each series of preferred stock.
  - Assumes that all outstanding convertible debt has been converted into shares of the applicable class of capital stock in accordance with its terms.*
    - *Unless such convertible debt will be converted in connection with an equity financing at the same price as the other new investors.

Capitalization Table Management – Practical Tips

- Law firms can (and commonly do) manage capitalization tables for companies.
  - Cap table management software helps (*e.g.*, CapShare and eShares).
- Always check the company's charter to confirm that the authorized capitalization provides enough shares for the proposed action.
- Do not update a cap table or stock ledger until all approvals (*e.g.*, board, stockholder, and third parties) have been obtained.
- Never promise equity issuances in percentages.

Preferred Stock – Anti-Dilution Protection

- Price-based anti-dilution protection
  - One of the most common rights given to investors participating in a preferred stock equity financing.
  - Share of preferred stock initially convert to common stock on a 1:1 basis.
  - The conversion ratio is typically calculated in the charter as the original purchase price of such series of preferred stock divided by the "Conversion Price," which is defined initially to be equal to the original issue price. (Any number divided by itself is 1.)
  - Anti-dilution formulas set forth in the charter change the value of the applicable "Conversion Price," which in turn changes the conversion ratio of that series of preferred stock into common stock.

Equity Incentive Plans Generally

- All equity incentive plans include a “reserve” or “option pool,” which represents the maximum number of shares of common stock (or options to purchase common stock) that the company may grant to its employees, consultants or other service providers.
  - Awards are typically subject to vesting schedules, such that upon the service provider’s termination all or a portion of the number of shares underlying such award are cancelled.
  - The number of shares cancelled return to the reserve, increasing the total number of shares that the board of directors is authorized to grant.
  - The reserve is calculated as the total number of shares authorized in the plan, *minus* the total number that have been granted, *plus* the number that have been cancelled.
  - Board and stockholder approval are required to increase the number of shares authorized under an equity incentive plan.

Preferred Stock – Liquidation Preference

- Another of the most common rights given to investors participating in a preferred stock equity financing is a liquidation preference.
  - A charter typically provides that holders of preferred stock are entitled to receive an amount equal to some multiple (*e.g.*, 1x) of their original purchase price before holders of common stock are entitled to receive any consideration in a liquidation event.
  - Liquidation preferences can be used by investors as a defensive (ensure return of capital) or offensive (ensure minimum gains) measure.
  - The most recently issued series of preferred stock generally is “on top” of the liquidation preference stack and is entitled to receive its preference amount before holders of any earlier series of preferred stock receive their preference amounts.
  - Multiple classes or series of stock may be *pari passu*, meaning that they are on the same level of priority in the preference stack.

Liquidation Preferences

- Types of Liquidation Preferences
  - *Non-Participating* – Holders of preferred stock are entitled to receive ***either*** their preference amount ***or*** the amount they would receive if their preferred stock converted to common stock, ***but not both***.
  - *Participating with No Cap* – Holders of preferred stock are entitled to receive ***both*** their preference amount ***and*** the amount per share that common stockholders are receiving, ***without any limit***.
  - *Participating with a Cap* – Holders of preferred stock are entitled to receive ***both*** their preference amount ***and*** the amount per share that common stockholders are receiving, ***but only up to limit*** typically set at some multiple (*e.g.*, 3x) of their preference amount.

Anatomy of a Pro Forma Cap Table

- A "pro forma" capitalization table is designed to show the impact of a proposed transaction (usually an equity financing) on the overall equity ownership of the Company.
- Key Components of a Pro Forma Cap Table for an Equity Financing:
  - Pre-money Valuation/Post-money valuation
    - Enterprise value of the Company; "art v. science"; 20% rule
    - Post-money valuation is the pre-money valuation plus the new money invested
  - Fully-diluted Capitalization
    - Increase in reserve for Option Plan
    - Impact of convertible debt and SAFE's (i.e. discounts, caps, etc.)
    - Down-rounds
  - Share pricing for the equity financing is determined by dividing the Pre-money Valuation by the Fully-Diluted Capitalization.
  - The "Golden Rule"
    - ***(DOLLARS INVESTED / POST-MONEY VALUATION) = (SHARES ISSUED / POST-MONEY FULLY-DILUTED CAPITALIZATION)***

Preferred Stock – Down Rounds

- A “down round” refers to an equity financing where the pre-money valuation agreed to by the investor and the company is lower than the post-money valuation of any prior round of equity financing.
  - Down rounds trigger the anti-dilution protections for previous series of preferred stock.

Liquidation Waterfall

- A liquidation waterfall is a model to calculate the dollar amounts that stockholders would receive upon an "exit event," such as a merger or acquisition.
  - Reflects the liquidation preferences and priority of each class of stock.
  - Useful to understand the different interests and incentives that stockholders of various classes may have with exit events at different price points.

Example – Capitalization Table

- The founders of this company hold most of the common stock.
- Its employees have received options to purchase common stock.
  - Several employees have exercised options and thus hold outstanding shares of common stock.
- The company issued a warrant to an early investor, which has not yet been exercised.
- This company has completed two rounds of financing, Series A and Series B.
  - Both series of preferred stock remain convertible to common stock on a 1:1 basis (i.e., there has not been a "down round" triggering antidilution adjustments).
  - Both of the Series A investors participated in the Series B financing as well.

Example – Series A Pro Forma

- This company proposes to conduct a Series A financing.
  - No preferred stock is outstanding (only common stock and options).
- The investors and the company have negotiated a pre-money valuation of $10,000,000 and an aggregate investment amount of $5,000,000.
  - Post-money valuation will be $15,000,000.
  - Lead investor will contribute $3,000,000 of the $5,000,000.
- Target post-closing option pool = 10%.
  - The option pool increase is included in the pre-money fully-diluted capitalization for purposes calculating the Series A price per share.

Example – Liquidation Waterfall

- This company has completed four rounds of financing, Series A through Series D.
  - The price per share has increased in each round, from $1 in the Series A to $4 in the Series D.
- Series D has first priority (*i.e.*, top of the waterfall), followed by Series C, then Series B, then Series A, and then common stock at the bottom.
  - No series are *pari passu* with one another.
- Each series carries a **non-participating** liquidation preference equal to 1x the price per share paid for such series.