5 Practical Things To Consider Before Granting Equity Interests In Your New Company

Description

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When starting a company, founders are immediately faced with a series of decisions, many of which will have long-lasting impacts that may not become apparent for months or years. Founders need to decide in which state to form their business entity, the type of business entity, and the specific provisions to include in an operating agreement or shareholders agreement, as the case may be. Among the most important decisions that company founders need to consider are who they will bring on as partners, how much equity to grant the partners (if any), and the appropriate delegation of responsibilities between partners.

One of the biggest mistakes that company founders make is failing to treat equity like the precious and finite resource that it is. When companies are just starting out and have no revenue but plenty of expenses, granting equity often seems like a good way to purchase goods and services while saving cash. It is frequently only years later, when the equity has significant value, that all of those small, early grants create problems.

There are many reasons why founders should be careful about granting too much equity too early. This article doesn't discuss all of the potential issues but highlights a few of the important ones.

The first is that depending upon the applicable state law, owners of closely held business entities may have heightened duties to one another. For instance, under Massachusetts common law, owners of closely held companies owe one another a fiduciary duty of utmost care and loyalty. This is a high standard of care, and not one that company founders should take on lightly. As an example, under Massachusetts law, when founders grant their employees or service providers small amounts of equity, the relationship changes from an employment or independent contractor relationship to a fiduciary relationship. The impact can be significant – for instance, terminating an employee who is also an equity owner can give rise to a breach of fiduciary duty claim for an attempted freeze-out of the individual from the company.

Second, lenders and investors typically prefer to lend or invest to companies with uncomplicated ownership structure. The reason is simple — the fewer owners a company has, the easier it is to obtain equity holder approval and the less likely it is that equity holders will dispute company actions. Companies with many minority owners can sometimes end up spending a significant amount of extra time and money either obtaining necessary consents from equity holders or buying out minority equity holders to clean up their ownership structure. Saving a few dollars early on is often very quickly outweighed by the costs (both in term of resources and time wasted) of dealing with a large number of owners with small ownership interests.

Third, even where the company founders may begin with similar responsibilities and levels of contribution to the company, it is not uncommon for one or more founders to fully invest their time and energy in the business, while one or more other founders decide relatively quickly that they no longer want to contribute a significant amount of their time. Founders who grant equity to individuals who are not as committed to the growth and success of the business often find themselves carrying the load of a partner who just wants to come along for the ride. Absent a well-drafted shareholder agreement or operating agreement specifically addressing these issues, there is no easy way to remove the non-performing individual from the company. As mentioned above, terminating a minority owner-employee (at least under Massachusetts law) can result in a claim for breach of fiduciary duty and potentially lead to litigation.

Fourth, although granting a small amount of equity in the company's early stages may seem like a way to save money on goods or services, if and when the company becomes successful, even a small amount of equity is likely to become much more valuable than the goods or services that the equity-holder originally provided. No founder wants to work for years to build a business and achieve a multi-million-dollar exit, only to be forced to share the proceeds with minority equity holders who have barely contributed to the growth of the company. Even small grants of equity can become incredibly valuable if the exit is large enough. Who among us would not be thrilled to have been granted a .001% interest in Facebook shortly after its founding?

Finally, the more equity that founders grant early in the company's life, the less equity there is available to grant to investors and employees down the road without diluting the founders. If a founder grants equity early on, there is an increased likelihood that the company will need to authorize and/or issue more equity in the future, diluting the founder's interest in the company. This issue is compounded if the company needs to seek outside investors, who will typically require the creation of a class of preferred stock that will dilute the founder(s) further. In the long term, this could result in the founder(s) losing his, her, or their position as majority owner(s) of the company, along with control of the company. Equity should be reserved for recruiting and retaining those service providers and investors who are essential to the company's growth and success.

Although granting equity interests to friends, family, and service providers might seem like a good way to expend company resources in the early days when cash is tight, doing so often comes with major risks and unanticipated costs down the road. Choosing business partners strategically and sparingly is the best approach to ensure long-term harmony between and among partners.

If you are starting a business and have questions about how best to structure your company, please reach out to Brian Reilly or Colin Coleman at Partridge Snow & Hahn LLP. A version of this article is published in Providence Business News and can be viewed here. (Subscription required)

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