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Electronic Equity Management Platform for Privately-Held Companies: Benefits, Risks, and Costs

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ELECTRONIC EQUITY MANAGEMENT PLATFORMS FOR PRIVATELY-HELD COMPANIES: BENEFITS, RISKS, AND COSTS

*George Akers**

Any lawyer or company that has worked with paper stock certificates, paper option agreements, and other paper-based securities knows how cumbersome, time-consuming, and problematic they can be.¹ The printing, mailing, cover letters, handwritten signatures, scanning, and ledger-updating can consume substantial billable legal time for what is essentially just paper pushing. Paper-based securities are also highly susceptible to typos, miscalculations, use of stale forms, or being lost or destroyed, all of which are problems that require additional paperwork and legal time to correct. In the middle of all these issues is the additional burden for the company or its counsel to manually maintain a capitalization table (“cap table”) and ledger to track all these securities, usually on an Excel spreadsheet, which must be continually and manually updated with every new stock issuance, option grant, option exercise, and other security issuance. Since early-stage private companies are usually more focused on growing the company than keeping good records, these cap tables and ledgers are usually out-of-date, incomplete, or incorrect by the time the company has a financing or exit transaction, at which point the lawyers for the company must spend significant billable time to verify, update, and correct issues with the company’s cap table and other equity-related documentation.

Fortunately, online software-as-a-service (“SaaS”) platforms have emerged in recent years to streamline and organize the issuance and management of securities for early-stage private companies and their lawyers by making the documents involved all electronic. These equity management platforms (“EMPs”)—also sometimes referred to as “cap table management

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¹ See, e.g., Sarah Buhr, *Cap Tables May Be Broken But What Can Be Done To Fix Them?*, TECHCRUNCH (Jan. 5, 2015), <https://techcrunch.com/2015/01/05/cap-tables-may-be-broken-but-what-can-be-done-to-fix-them/> (regarding the problems with traditional paper-based securities and capitalization tables).

platforms”²—vary in their offered features but generally all allow for the electronic issuance of securities and provide a more dynamic and automated cap table and ledger. Beyond the issuance of electronic securities, these platforms are also able to offer conveniences such as real-time tracking of vesting progress, modeling of financing and exit scenarios, securities laws compliance checks, inexpensive 409A valuations, and more. However, despite the various benefits to EMPs, there are also risks to using these platforms, some of which can be and are managed by the EMPs, and others that are simply unmanageable and inherent to any electronic-based system. Finally, subscription costs for EMPs range from free to very high (usually based on the size of the cap table or offered features), meaning that companies will need to consider whether their desired EMP makes economic sense for them. This article lays out in general terms the benefits, risks, and costs of EMPs so that companies and their lawyers can have a framework for making an informed decision about whether to use an EMP and, if so, the factors to consider in selecting one.

I. BENEFITS

There are a variety of benefits to using an EMP but they all essentially come down to time-savings and cost-savings, both for companies and their lawyers. Since law firms generally bill by the hour, the time-savings created by EMPs generally lead to reduced legal bills for clients and reduced write-offs for law firms who have fee-sensitive clients. Below are some of the most valuable time-saving/cost-saving features offered by one or more EMPs. Readers should note, however, that not all EMPs have the following features or the same features, so companies and lawyers interested in using an EMP should carefully evaluate it to ensure that it contains the features most important to them.³

² I prefer the term “equity management platform” over “cap table management platform” because the latter does not convey the fact that these platforms do much more beyond providing a dynamic cap table (e.g. issuing electronic stock certificates).

³ Many EMPs list out all their features in an index, such as eShares and Capshare, so interested persons can easily see if the platform contains their desired features. *See, e.g., Feature Index*, ESHARES, <https://esharesinc.com/product/features> (last visited May 10, 2017); *See, e.g., Features*, CAPSHARE, <https://www.capshare.com/features> (last visited May 10, 2017). Some EMPs have also provided feature comparisons on their websites to distinguish themselves from competitors. *See, e.g., Capshare vs. eShares*, CAPSHARE, <https://www.capshare.com/compare/eShares> (last visited May 10, 2017). In full disclosure, the EMP I am most familiar with and use with most clients is eShares and so that is why most of the footnotes in this section only cite eShares as an example. However, there are several good EMPs out there, and in a more perfect world with more time I would cite more EMPs as examples.

A. *Issuing Electronic Stock Certificates*

Replacing paper stock certificates with electronic ones is one of the biggest ways that EMPs can save time and money. Prior to EMPs, when a private company needed to issue stock certificates, the following steps would generally need to be taken:

- (1) the attorney would provide the stockholder's information to a paralegal;
- (2) the paralegal would type up and print off the paper certificate;
- (3) the attorney would review the stock certificate for accuracy;
- (4) the paralegal would draft a cover letter and mail the certificate to the company for signature by the company's officers;
- (5) the company would receive the certificate and have the officers sign by hand;
- (6) the company would scan and email a copy of the signed certificate to the law firm for the firm's records;
- (7) the paralegal would save the copy of the signed certificate to the law firm's files and update the Excel spreadsheet stock ledger and cap table with the certificate's information; and
- (8) the company would then mail or personally deliver the certificate to the stockholder.

This whole process of issuing a paper stock certificate can take several days from start to finish and can incur significant legal fees and shipping costs (if using FedEx, UPS, or another overnight carrier). The pain continues later on if the certificate needs to be canceled or if shares need to be transferred, requiring the following additional steps:

- (1) the law firm would email or call the stockholder to request that he/she mail the certificate to the firm;
- (2) once the certificate is received by mail, the paralegal would then stamp "canceled" on the certificate, save a scanned copy to the firm's records, and place the paper copy in the company's minute book or files;
- (3) the paralegal would then create a new stock certificate for the recipient of the transferred shares (if shares are being transferred), and the rest of the certificate issuance process described above would continue from there.

With EMPs, however, the attorney can quickly input the stockholder's information into the EMP platform, click a button to send the electronic certificate to the officers for electronic signature, the officers would receive an email from the EMP requesting their signature, they would click the link in their email and electronically sign, and then the signed certificate would be automatically emailed to the stockholder for his/her acceptance.⁴ Any cancellation⁵ or transfer of shares⁶ can likewise be done with a few clicks of a button by the attorney. The legal time-savings in this one respect can be quite meaningful, and this is just one feature of EMPs.

B. Issuing Options and Other Securities Electronically

EMPs also allow lawyers to quickly and electronically issue options, warrants, and convertible securities, significantly cutting down on legal time and costs. Before EMPs, when a company wanted to issue stock options, the following steps would generally need to be taken:

- (1) the lawyer would draft Board resolutions approving the options;
- (2) the Board would approve the resolutions either at a Board meeting or by written consent;
- (3) the lawyer would fill in the company's form of option agreement for each of the option recipients;
- (4) the lawyer would email the option agreements to the company for the company and option recipients' signatures;
- (5) the company and option recipients would sign the option agreements⁷;
- (6) the company would scan and email the signed option agreements back to the law firm;
- (7) the paralegal would save the copies of the signed option agreements to the firm's files; and
- (8) the paralegal would update the option ledger with the new options.

⁴ See, e.g., *Issue Share Certificates—Individually*, ESHARES, <https://support.esharesinc.com/article/60-issue-share-certificates-individually> (last updated Mar. 27, 2017).

⁵ See, e.g., *Cancel a Certificate*, ESHARES, <https://support.esharesinc.com/article/569-cancel-a-certificate> (last updated Mar. 27, 2017).

⁶ See, e.g., *Transfer Shares*, ESHARES, <https://support.esharesinc.com/article/64-transfer-shares> (last updated Mar. 27, 2017).

⁷ Electronic signature platforms like DocuSign have helped reduce some of the inefficiencies in this process and other processes requiring signatures. This list of steps for issuing options assumes that an electronic signature platform such as DocuSign is not being used.

With EMPs, the steps for issuing options are mostly handled automatically by the EMP and include:

- (1) the lawyer inputs the information for the new options into the EMP as a draft and attaches the pre-saved form of option agreement and stock incentive plan to the option grant by clicking a button;⁸
- (2) the lawyer marks the drafts of option agreements as requiring board approval;⁹
- (3) the EMP automatically populates a board resolution to approve the new options and, once approved by the user, the EMP sends it to the board members' email addresses for electronic signature;¹⁰
- (4) the board members sign the board consent electronically;¹¹
- (5) the option agreements are then automatically sent to the company's designated officer for signature;¹²
- (6) once signed by the officer, the option agreements are then automatically sent to the option recipients for their signatures;¹³ and
- (7) the option ledger on the EMP is automatically updated with the new options.¹⁴

Similar time-saving functionality is also generally available for issuing other securities such as warrants,¹⁵ convertible notes,¹⁶ SAFEs,¹⁷ and other convertible instruments.

⁸ See, e.g., *Issue Option Grants—Individually*, ESHARESINC.COM, <https://support.esharesinc.com/article/49-issue-grant-options-individually> (last updated Mar. 15, 2017). For those lawyers curious about the contract formation aspect of this process, EMPs like eShares have the option recipient agree that the platform's "Grant Summary" containing the key option information (e.g. exercise price, number of shares) incorporates the form of option agreement for the remaining information. Therefore, the lawyer can just leave the form agreement blank for the key information since the "Grant Summary" operates to provide that information instead. See, e.g., *Accepting an Option Grant*, ESHARES, <https://support.esharesinc.com/article/108-accepting-an-option-grant> (last updated Feb. 8, 2017); see, e.g., *Manage Your Equity Plan Documents*, ESHARES, <https://support.esharesinc.com/article/512-manage-your-equity-plan-documents> (last updated Mar. 16, 2017).

⁹ See, e.g., *Sending Option Drafts for Board Approval*, ESHARES, <https://support.esharesinc.com/article/660-sending-option-drafts-for-board-approval> (last updated Mar. 22, 2017).

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ See, e.g., *Issue Warrants—Individually*, ESHARES, <https://support.esharesinc.com/article/55-issue-warrants> (last updated Mar. 15, 2017).

¹⁶ See, e.g., *Issue Convertibles—Individually*, ESHARES, <https://support.esharesinc.com/article/70-issue-convertibles-individually> (last updated Mar. 15, 2017).

C. *Dynamic and Reliable Cap Table and Ledger*

EMPs also cut down on billable time by simply providing reliable, up-to-date, and accurate cap table information that does not require much verification, correcting, or updating, if any. Before EMPs, whenever a company needed to issue new shares or options, the company's lawyer would need to review the company's documentation to verify the number of shares/options outstanding and the number of shares/options that are authorized by the company's charter or option plan. Additionally, if the company was going through a financing or M&A deal, then the company's lawyer would need to spend additional time reviewing all of the paper stock certificates, stock purchase agreements, option agreements, and board approvals for the same to ensure that the cap table and ledger are accurate and up-to-date. Since many companies' Excel-based cap table and ledger are not always manually updated as they should be, some degree of verification of those documents is required at the time of each new issuance, financing, or exit transaction. With EMPs, however, the attorney can usually know with near certainty that the cap table and ledger on the EMP are up-to-date because all issuances, cancelations, or transfers are *effected* (and automatically *reflected*) on the platform. The lawyer can also know with high certainty that the securities were all properly authorized by the Board since the EMP may require inputting a Board authorization date for each issued security,¹⁸ and some EMPs also allow for Board approval of the security directly on the platform.¹⁹ Finally, if the lawyer has been updating the EMP to reflect amendments to the charter²⁰ and option plan²¹ regarding the number of authorized shares and options, then the lawyer can know the number of shares or options available for further issuance without needing to do additional verification. The EMP will take into account options that have been exercised or terminated in its calculation of available shares under the option plan because such exercises or terminations are effected (and reflected) on the platform itself.²² Removing the need to perform extensive diligence on a

¹⁷ See, e.g., *Issue Safes*, ESHARES, <https://support.esharesinc.com/article/327-issue-safes> (last updated Mar. 15, 2017).

¹⁸ *supra* note 8.

¹⁹ *Sending Option Drafts for Board Approval*, *supra* note 9.

²⁰ See, e.g., *Tracking, Adding, and Updating Authorized Shares*, ESHARES, <https://support.esharesinc.com/article/62-tracking-adding-and-updating-authorized-shares> (last updated Mar. 27, 2017).

²¹ See, e.g., *Add Shares to the Option Plan*, ESHARES, <https://support.esharesinc.com/article/48-add-shares-to-the-option-plan> (last updated Mar. 15, 2017).

²² If an optionholder is terminated from the company, then the lawyer can simply click a button showing that the person's service status is terminated and the EMP will automatically terminate the options and return

company's cap table can significantly reduce billable attorney time and legal fees.

D. Other Features

EMPs offer plenty of other features that also save time and money, including the following:

- Automated Compliance Checks
 - With regard to options, EMPs can also automatically check for and ensure compliance with certain securities laws,²³ thereby reducing the likelihood of errors that lawyers have to spend time fixing later on.
- Inexpensive 409A Valuations
 - EMPs are often able to offer 409A valuations that are much less expensive than valuations from traditional sources. Usually, independent appraisals can cost anywhere from \$5,000, \$10,000, or \$25,000. However, some EMPs offer 409A valuations for as low as \$99 per month²⁴ for a 12-month subscription (i.e. \$1,188 per year).
- Historic Reports
 - EMPs let users generate historic cap table reports,²⁵ which can be useful, for example, when the company's accountants need to know what the cap table looked like as of the end of the previous fiscal year.
- Pro Forma Financing and Waterfall Models

them to the pool if the person does not exercise their options within the specified post-termination window (often 90 days). *See, e.g., Terminating An Option Grant*, ESHARES, <https://support.esharesinc.com/article/89-terminating-an-employees-option-grant> (Mar. 15, 2017).

²³ For example, if the company has relied on an independent appraisal for determining the fair market value ("FMV") of its common stock in compliance with section 409A of the Internal Revenue Code ("409A valuation"), then some EMPs will alert the user if the 12-month safe harbor period for that 409A valuation has expired so that the company can either obtain a new 409A valuation or have the Board determine the FMV in its own good faith judgment. Also, some EMPs check for compliance with the "\$100K Rule." 26 U.S.C. § 422(d) (2012); 26 U.S.C. § 422(b)(6) (2012); 26 U.S.C. § 422(c)(5) (2012); *see, e.g., ISO/NSO Split*, ESHARES, <https://support.esharesinc.com/article/531-iso-nso-split> (last updated Mar. 27, 2017).

²⁴ *See, e.g., Get a Signed 409A Valuation for as Little as \$99/mo*, CAPSHARE, <https://capshare.leadpages.co/409a-lp-capsharifed/> (last visited May 10, 2017).

²⁵ *See, e.g., Exporting the Cap Table*, ESHARES, <https://support.esharesinc.com/article/95-exporting-the-cap-table> (last updated Mar. 17, 2017).

- EMPs also allow users to generate pro forma cap tables for proposed financings²⁶ and waterfall analyses²⁷ to see what different security-holders would receive as consideration under different purchase prices for the acquisition of the company.
- Electronic Minute Book
 - Finally, some EMPs can also serve as electronic minute books, allowing companies to store their board and stockholder consents/minutes, charter, option plan, and other corporate documents all in one easily-accessible and easily-shareable location.²⁸

II. RISKS

Despite the many benefits of EMPs described above, companies and lawyers interested in using EMPs should also be aware of the potential risks and ensure that their EMP of choice adequately addresses those risks where possible.

One of the main risks in using an electronic platform is the potential for data loss. In other words, will you lose your capitalization records and documents if the EMP company goes out of business, its servers or systems crash, or unauthorized persons alter the data? Many EMPs address this concern on their websites, stating, for example, that they back up data on servers in multiple locations²⁹ and on a frequent basis.³⁰ Other EMPs state that they have a “wind down” escrow fund set aside to pay for the transition of all of their customers back to paper in the event of bankruptcy for the EMP.³¹ Companies and their lawyers should consult with their respective information technology

²⁶ See, e.g., *Pro Forma Round Modeling Spread Sheet*, ESHARES, <https://support.esharesinc.com/article/94-pro-forma-round-modeling-spreadsheet> (last updated Mar. 17, 2017).

²⁷ eShares requests that users “contact valuations@esharesinc.com with questions” on using this feature so some human interfacing may be required.

²⁸ See, e.g., *Manage Your Company Library*, ESHARES, <https://support.esharesinc.com/article/609-manage-your-company-library> (last updated Mar. 16, 2017).

²⁹ See, e.g., *eShares Security Procedure*, ESHARES, <https://support.esharesinc.com/article/97-eshares-security-overview> (last updated Mar. 15, 2017).

³⁰ Capshare similarly says that they perform backups on a daily, weekly, and monthly basis, storing such data in multiple facilities and on multiple devices within each facility. *Security Policy*, CAPSHARE, https://www.capshare.com/security_policy (last visited May 10, 2017).

³¹ *What Happens if eShares Goes out of Business?*, ESHARES, <https://support.esharesinc.com/article/150-what-happens-if-you-go-out-of-business> (last updated July 25, 2016).

(“IT”) personnel to evaluate whether the EMP in question adequately addresses the risk of data loss.

Considering that stockholder information for privately held companies may be quite sensitive and confidential, companies should also ensure that the EMP adequately addresses the risk of a data breach. Many EMPs address the issue of data security on their websites, listing out security measures such as two-factor authentication,³² encryption,³³ firewalls,³⁴ employee background checks,³⁵ and employee confidentiality agreements.³⁶ IT personnel should also verify whether the EMP provides an adequate level of protection against a potential data breach.

Finally, the electronic and internet-dependent nature of EMPs means that lack of data access is also a risk. In other words, what happens if the power or internet is temporarily down? There may not be much that can be done to manage this particular risk, and unsurprisingly there were no mentions of solutions to this risk on the EMP websites reviewed for this article. Fortunately, however, widespread and long-term loss of power and/or internet service is not common in the United States and most other developed nations, and so this should be a tolerable risk to bear in exchange for the benefits of using an EMP.

III. COSTS

Pricing structures for EMPs vary widely, so companies should consider their desired EMP’s price to ensure that it makes economic sense for their particular company. Some EMPs are actually free in certain circumstances,³⁷ others cost a few dollars per security-holder,³⁸ others have different pricing

³² *eShares Security Procedure*, *supra* note 29.

³³ *Id.*

³⁴ *Security Policy*, *supra* note 30.

³⁵ *Security Procedure*, *supra* note 29.

³⁶ *Security Policy*, *supra* note 30.

³⁷ *See, e.g., Pricing*, CAPSHARE, <https://www.capshare.com/pricing> (last visited May 10, 2017) (showing that Capshare is free if the company has less than 20 security-holders); *See, e.g., Cap table management and insights for founders*, CAPTABLE.IO, <https://captable.io/> (last visited May 10, 2017) (claiming that it is a “free tool” on its homepage); REPORTALLY, <http://www.reportally.com/> (last visited May 10, 2017); *Pricing Guide*, CAPYX, <https://www.capyx.com/pricing> (last visited May 10, 2017) (showing that Capyx is free if there are 10 or less security-holders).

³⁸ Capshare costs \$2 per security-holder for their “Pro” level of features, and \$5 per security-holder for their “Enterprise” level of features. *See also Pricing*, *supra* note 37.

tiers based on the total number of security-holders,³⁹ and others do not make their pricing publicly available, but instead require prospective customers to contact the EMP directly to receive pricing information.⁴⁰ The 409A valuation service typically costs extra and is usually charged on a monthly subscription basis with different pricing tiers based on what the most recent equity financing round was (e.g. Series Seed, Series A, Series, B, etc.).⁴¹ The good news though, as mentioned previously, is that the cost of subscribing for an EMP's 409A valuation service is typically very low.⁴² Companies that are already far along and have large, complicated cap tables should also consider the potentially high cost of migration onto an EMP, which is usually done by a lawyer or one of the EMP's on-boarding specialists, and can be quite costly.

CONCLUSION

Although EMPs entail some new risks not previously inherent in paper-based securities and they can (in some cases) cost hundreds or thousands of dollars, the risks can mostly be managed, the costs can potentially be minimal, and the benefits that EMPs offer in lower legal bills, net reduced risk, and overall convenience can make them a smart, net cost-saving solution for many companies. For me personally, as a practicing attorney, I'm never going back to paper.

³⁹ See, e.g., *Pricing Guide*, *supra* note 37.

⁴⁰ See, e.g., ESHARES, <https://esharesinc.com/> (last visited May 10, 2017); see, e.g., GUST EQUITY MANAGEMENT, <https://equity.gust.com/new> (last visited May 10, 2017); see, e.g., *Shareworks Cap Table*, SOLIUM, <https://solum.com/product/cap-table/> (last visited May 10, 2017).

⁴¹ See, e.g., *Pricing*, *supra* note 37; see e.g., *Pricing Guide*, *supra* note 37.

⁴² See, e.g., *Get a Signed 409A Valuation for as Little as \$99/mo*, *supra* note 24 (stating that 409A valuation subscription is only \$99 per month for a 12-month subscription, i.e. \$1,188 per year).

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APPENDIX

ILLUSTRATIVE LIST OF EMP SERVICE PROVIDERS⁴³

eShares (<https://esharesinc.com/>)

Capshare (<https://www.capshare.com/>)

Solium Shareworks (<https://solium.com/shareworks/>)

Gust (<https://equity.gust.com/new>)

Reportally (www.reportally.com)

Captable.io (<https://captable.io/>)

Capyx (<https://www.capyx.com/>)

Certent (www.Certent.com)

Truequity (www.truequity.com)

OptionTrax (www.optiontrax.com/)

⁴³ This list was generated from performing a simple Google search for “equity management platform” and “cap table management platform” and listing the top results from the first 2 pages of results.