



Lowenstein Sandler's Emerging Companies, Venture Capital Podcast: The Founder's Hour

Episode 4

[Laura Cicirelli](#) and [Eric Weiner](#)

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- Eric Weiner:** Hi, everybody. Welcome to *The Founder's Hour*, from Idea to Exit, Happy Hour Conversations on Forming, Growing and Selling a Business, a Lowenstein Sandler podcast series. I am Eric Weiner.
- Laura Cicirelli:** And I'm Laura Cicirelli.
- Eric Weiner:** And we're partners in Lowenstein's Emerging Companies and Venture Capital Group. Whether you're forming your first company, negotiating your first term sheet, or preparing for an exit, the decisions you make early can shape your company's future.
- Laura Cicirelli:** Each month, we bring the conversations happening at our New York office to the broader founder and investor community, sharing practical, legal and business insights to help you navigate every stage of your company's growth.
- Thank you, everyone for joining us. Today we're talking about valuations and just cap table math, which is kind of a hard thing to talk about on a podcast when you're not looking at anything visually and when you're considering numbers and percentages. But we're talking very high level here, and we want to kind of quickly take us from formation, to a convertible financing round, and then we'll end with the equity financing round, and kind of what does that look like for the founders and those on the cap table, and the dilution that hits them over time.
- So, taking a step back to formation. So, we have co-founders. That's kind of been our theme with the podcast, assuming that we have co-founders at formation, 50/50 owners of the company.

And I think just for quick and simple math, and this is the only time we'll really use numbers in this podcast.

Eric Weiner: But we are going to be talking about fractions, so get excited.

Laura Cicirelli: Lots of math stuff. So, we can assume that each owner of the company, each founder has 1.8 million shares of common stock, 50/50. And so really, the first thing that happens a lot of times is that we put in place an equity incentive plan to incentivize our service providers.

Eric Weiner: I think, so let's quickly step back. Two founders, they each own 50% of the company. In our example, they own 1.8 million shares each. So, if Laura and I were the co-founders of the business, we each owned 50% of the business, and we gave, we each had 1.8 million shares each. And we promise we're not going to be talking about numbers that much more. 100% of the company would be 3.6 million shares.

Laura Cicirelli: Correct.

Eric Weiner: In that case, I would own 1.8 million over 3.6 million 50%. Laura would do the same, 100%. Now, if the company wants to adopt an equity incentive plan, and let's assume you know, that equity incentive plan would be to incentivize service providers of the business, employees, consultants, etc. You want to give them options, stuff like that.

Laura Cicirelli: And we'll talk about that in further detail in a future podcast, why it needs to be through that plan, but that is that is how it's done.

Eric Weiner: Right? And that'll be a fun podcast. And we say that that that plan is going to be 10% pool. What would happen in that case is, remembering that we now have a \$3.6 million shares fully diluted cap table, because we each own 1.8 million, we would create a plan that had 400,000 shares in it. And what would be the result of that would be: Laura owns 1.8 million. I own 1.8 million. That's 3.6, and there's a 400,000 share pool that makes the denominator go from 3.6 million to 4 million. And 400,000 over 4 million is 10%.

Laura and I, on a fully diluted basis, which we will explain in a minute, will be diluted by that additional 400,000 shares that just came on to our cap table and increased the denominator from 3.6 million to 4 million.

Laura Cicirelli: Correct. And I think understanding those fractions is super important. And so outstanding versus fully diluted basis. You used both of those terms. So, what do those two things mean. So, on an outstanding basis, that is what do we actually hold as of today. If this company were to sell today, what would we own in our company. And still in our example we'd each still own 50/50.

Even though that equity incentive pool was in place, it's not issued. It's not outstanding. No one actually holds those shares as of today. They're just reserved in that pool. So, we still are 50/50 owners of our company. On a fully diluted basis, that's taking into account anything that's on the cap table that could be issued and outstanding at some point in time. Whether it be under an equity incentive pool, under a warrant, if anything is issued to a service provider and they actually hold an option... all of those things are now taken into the denominator, what do we own? And it's going to be less than 50%.

Eric Weiner: Now we own 45% each.

Laura Cicirelli: Exactly.

Eric Weiner: We own 90% each. The option pool is a use it or lose it, basically. So if, to Laura's great point, you know, we form the business, we create an option pool, but we are lucky enough that some buyer wants to buy the business before we've ever issued an option out of that pool, they fall off the denominator.

The fully diluted denominator was 4 million. The issue, an outstanding denominator in this example was 3.6 million. And if we're sold before we ever use any of those shares out of the option pool, that denominator becomes 3.6 million, because that's all that's ever been issued. And Laura and I get to split the proceeds 50/50. I assure you, we will be happy.

Laura Cicirelli: Yes, absolutely. So, moving on to the next stage where we're now issuing convertible securities, which we've talked about in a prior podcast.

Eric Weiner: Safes. Convertible notes.

Laura Cicirelli: Exactly right. So, what happens when those are issued? And the answer is actually nothing to the cap table at this point in time. Right?

Eric Weiner: Correct.

Laura Cicirelli: So if I, in this company we have, right, where we have the 10% option pool on an outstanding basis, where 50/50 owners, if we go and raise even \$10 million under a safe, that day on our cap table, we still come off as the 50/50 owners of the company on outstanding basis, and 45% each on a fully diluted basis.

Eric Weiner: Using the example from before, yes.

Laura Cicirelli: Exactly right. It is not until those convertibles convert in a priced round where we actually see the dilution to us. But again, please listen to our prior podcast. We're not saying to just go and issue a bunch of convertible securities.

Eric Weiner: There will be an impact to you.

Laura Cicirelli: There will be an impact in a sale event and how those safe holders or convertible note holders receive proceeds in the sale. But we're just saying, voting, you know who holds the voting rights of the company, we are 50 over 50 owners of the company as of that day, still.

Eric Weiner: Right. And so, to now think about we'll do a little bit of the economics of like a, say for example, even though we have talked about it in the prior podcast, but it's good to bring it into this discussion. If you raise on a safe... I think Laura said it would be a \$10 million safe, which is awesome if you are getting it, because that's a big one.

But let's assume, for the sake of our discussion, that the safe is \$10 million investment and it had \$100 million post money valuation cap. Effectively what the company is selling and what the investors in the safe are buying is about 10% of the business as of immediately prior to the conversion of those safes into an equity round, or in connection with the sale of the business.

So, even though the cap table in and of itself will not have any modification, if you sell \$10 million of safes with a \$100 million post money valuation cap, you should assume, and we're taking out complexities with discounts and other terms, but for the very basics, you should assume you've just kind of sold 10% of the company.

Laura Cicirelli: Yeah, this is certainly not giving you the green light to go out and raise \$10 million under a safe and think it has no implications or no consequence to you upon a sale event or anything like that.

Eric Weiner: That's right.

Laura Cicirelli: Yeah. And so now let's talk about actually going on to the price round. And that's really where we want to focus this podcast on. So, we can kind of go in with our example of, not using numbers, just high level, two founders, there is some equity incentive pool in place, and we have convertibles outstanding. And now we get a term sheet for a price round.

And we see something in there that says the pre-money valuation is going to be X amount. And so, what does that kind of mean? What should founders be thinking about when they see that?

Eric Weiner: Yeah, and this is where the fractions really come into play. You own a portion of the company in shares, and there's all the shares that everybody owns, or have been reserved in a option pool or something, that is... The numerator is what you own. The denominator is what everybody owns or has been reserved for everybody.

Laura Cicirelli: The fully diluted number, bringing in the term from prior. Right?

Eric Weiner: Exactly. So, when you think about a pre-money basis.

Laura Cicirelli: The pre-money is the fully diluted ownership of the cap table prior to this new round.

Eric Weiner: Which we said. Ok.

Laura Cicirelli: Right. Sometimes in a term sheet there are things that are specifically noted to be included in the money even though they don't exist actually. An investor is saying "I want those to also be included in that denominator, because I don't want it to impact me."

Eric Weiner: Right. So, if you are thinking about an investor's going to come in and put some money into the business, they're saying that the denominator, for purposes of the cap table, gets increased before they put any money in. So, if you own a certain amount of shares, that equals a particular percentage before they put money in. If that term sheet says you're going to increase an option pool, or the safes or the

convertible notes are going to convert into the round, the term sheet is going to say that that all happens on a pre-money basis.

What that means is that the denominator that already existed in the existing cap table gets increased before they ever put any money in. Said in another way, the existing cap table in an our example that we were using, Laura and me, we're going to get diluted by anything that happens before the new money comes in, and the investors won't.

Laura Cicirelli: Exactly. And I think taking it back to the example from the beginning of, you know, I know we said we won't talk about numbers and whatnot, but our example of where the co-founders and there's an equity incentive pool in place; what it does is by putting more things in the pre money, it increases that fully diluted number so that our ownership, the way it went from 50 to 45, goes even lower.

Right. So, the existing cap table needs to get a smaller and smaller percentage to make room for those investors, and any type of equity incentive pool top off that's going to come in connection with this round, and safes that are converting; those need to come in and not be affected in the same way that the existing cap table is.

So, what does that mean? We have to squeeze down the existing people to make room for the new people to come in.

Eric Weiner: Because if I'm an investor and I say I'm buying 10% of your business for my money, I'm saying, "I'm buying 10% of my business for my money." So, if there is an increase to the option pool that we have negotiated, if there are outstanding safes that you've already sold, if there's a warrant out there that I know, doesn't matter.

Laura Cicirelli: Don't care what's out there, I need 10%.

Eric Weiner: Exactly. So that means, like I am going to go back to the numbers. I know we said we wouldn't, but in the example we use at the beginning of this podcast, we said it was 1.8 million each and a 400,000 share option pool. The denominator was 4 million.

Laura Cicirelli: Correct.

Eric Weiner: When there's a pre-money adjustment, that 4 million denominator goes up, and up, and up, for each increase into the option pool, any safe that gets converted into the round, before the investor's new 10%. So, if Laura and I owned 45% each, on a fully diluted basis of the

company prior to the equity round, before the new money comes in, we're going to own less.

Laura Cicirelli: Correct.

Eric Weiner: Because the denominator will be greater than 4 million to account for the increase in the option pool if there is one, and to account for the conversion of any convertible securities, if there are any, and then the money comes in.

Laura Cicirelli: Yeah. And so, the two things that we're including as examples, because I think we see them the most frequently; equity incentive pool increases and convertible securities. I think an equity incentive will increase, I see and really almost always in every deal that we do, it's a very rare occurrence when you see no equity incentive pool increase asked for, and the reason is, just what we said, an investor does not want to come in and say, "I'm purchasing 10% of the company on these terms..." Great. The deal closes. I have 10%, I own 10%. And then, oh, wait, we need to hire X, Y, and Z person, and we actually need to give them a point each, of the company.

And so now what I had once is 10% quickly within a month, is now down to nine point something percent. Not what I bargained for. So that is why an investor is going to say, "in connection with my round, everything in the pre-money, we need to increase the equity incentive pool to allow you to have some runway. That I have comfort that in the next 12, 18 months of your hiring needs, I am not diluted below my 10%."

Eric Weiner: Right. I think at some point in time, I like the 12 to 18 month example you used there, the companies can have a hiring plan, which we think is a reasonable metric to use for the option pool. If an investor is giving you money, they shouldn't be diluted an hour after they give you the money.

At some point though, you agree on what a hiring plan is, there's going to be shared dilution down the road, and it should be a reasonable time. It shouldn't be two months later. But you know, if you've used this pool, investor gives you money, you're using that money to hire people. Smart way to use the money. At some point, okay, you can share in the dilution. Completely reasonable.

Laura Cicirelli: Very common ask, reasonable ask. I say the things that are negotiated is, you know, what is the percentage going to be? Is it 5%? Is it 8%? Is it going to be 10% of the company available under the pool? And it's really just what are your needs? And it's a conversation with the investor.

Eric Weiner: That's why I think your 12 to 18 month example is a good one, is that it shouldn't be arbitrary. So, if a term sheet says we're going to have a 15% pool and it's just because 15 sounds good, not great.

Laura Cicirelli: Not good.

Eric Weiner: But if there's if you say look, yeah, over the next 12 to 18 months, I think I am going to need 15% of my post-money cap table to hire, then it's probably the right number. But if the right number is 5%, the right number is 5%. And I think, to the to go back to what we've been discussing about this sort of cap table math, if there is a percent option pool, the term sheet is going to say it's going to be 10% of the post-money cap table, but the adjustment is going to be on a pre-money basis.

So, this is where we were talking about the denominator sort of increasing before the money comes in. It also means that the pre-money value is going to go down by some percentage. So, the price per share goes down. It is generally a price negotiation which is why it is an important part of the term sheet to get a line down with the investor.

Laura Cicirelli: And really every little bit moves the needle when it comes to price.

Eric Weiner: You know. So now look we just talked about the option pool. The other thing we want to just address quickly about the safes that are converting in this round. And we were talking about how they're a pre-money hit on the existing cap table. We did also mention earlier in the podcast about, you know, if it was a \$10 million safe on \$100 million post-money, that is basically 10% of the company.

That's true. So, what happens there is that the safe holders are going to receive shares in this round that equal about 10% of the business, you know, give or take. There are some adjustments potentially. But that's right before the new money comes in. So, when you're raising a safe, whether you're the investor or the company, you need to know that the safes get diluted by the new money.

So, the safe, and the \$10 million safe on \$100 million post-money value basically means, again, not precise, basically means, as of immediately prior to the new money coming in, the safe holders are going to own 10% of the company, and then they're going to be diluted one second later when the new money comes in.

It is not an evergreen 10%. It is not. It doesn't mean you get it forever. It just means as of immediately prior to the new cash, you own about 10%.

Laura Cicirelli: And we don't need to get into the weeds with it, but also, they are going to be diluted the same way that the existing shareholders are with the new money. And that means with that increase to the equity incentive pool, safe holders are also going to be diluted by that, right? So, it's actually what is the snapshot a minute before this deal closes.

That equity incentive pool increase is happening after, in connection with the deal. So, they are getting the hit the same way the founders are with that equity incentive pool increase.

Eric Weiner: Yeah, and I guess if I would try to put something in your brain to picture, I guess left to right: founders get diluted by the safe, founders and safe holders get diluted by the safe and the increase in the option pool, and investors get whatever they're buying.

Laura Cicirelli: Yeah. Investors walk away pretty.

Eric Weiner: Left to right, numerator stays the same. Denominator gets bigger. Left to right, deals done for the investors make their investment. They get what they own, and they'll get diluted in the next round. But that's basically how it works. I guess the left to right, on the left side is the pre. On the right side is the post.

Laura Cicirelli: Yeah. And so, I think it's just important what the biggest takeaway we'd like founders to take from this podcast is that when you see a pre-money valuation in your term sheet and it's something great amazing. We were expecting 20 million. We got 25. Excellent. But... if there is an equity incentive pool say 15%, and you only need five, even though that dollar figure is something that's enticing to you, it's not really going to be that dollar figure because of everything we've said on this podcast. It is going to be, everything's taken into the pre, so it's kind of pushing that valuation down further and further.

Eric Weiner: Yeah, I like to think about it like effective pre-money. You've got like the term sheet pre-money says something, but then after you do all the mechanics we're talking about, it's actually lower. But the good news is that when you do a public announcement about the deal, you can use whatever is in the term sheet. You don't have to worry about the adjustments.

Laura Cicirelli: Exactly right. Just be thoughtful about that. And if there's convertibles when you're issuing convertibles, and now you see how it actually affects your ownership at the end of the day, when these things do convert in connection with the price round, be cognizant of that and don't just keep doing safe round after safe round without knowing the dilution implications to you.

Eric Weiner: I think that's the point. I think that's a great point, is that anytime you issue a share, the real gold of the business is going out. You are owning less of the business. You're not doing anything wrong when you do that. But founders should be careful, particularly when it comes to convertible securities, I think, just to make sure you're thinking about it.

Laura Cicirelli: Yeah. And there's ways to change the ownership of the cap table over time. Recaps, and things like issuing the founders more equity. But it's not going to be the most tax efficient thing for you, and it's going to be costly.

Eric Weiner: You don't want to do it.

Laura Cicirelli: And you don't want to. Exactly right.

Eric Weiner: The goal is, hopefully, at the very beginning, starting back to when Laura and I formed this company; 1.8 million shares each, and then we raised a safe. The goal is to set the business up so that you never have to do a recap. So that everybody, at the end of the day, has a fair percentage of the business for their contributions, whether that's in sweat, or cash, or whatever. That's really the goal.

And one thing that you should always be thinking about; you can talk to us about it, or an advisor, or whomever is: When you're doing a financing round, don't just think about that round. How does that set you up for the next round, and the next round? And the most successful, generally the most successful businesses that we work with, they raise money more than once... multiple times over multiple

rounds. So, there's going to be dilution in each case. There's nothing wrong with that.

But if you set the cap table up right from the beginning, and you think about the implications of each subsequent round, you can get to a place where you don't need those recaps.

Laura Cicirelli: Yeah, and the last point I'll make is a lot of times founders think, "oh, you know, the investor is not going to like me pushing back on the equity incentive pool." But if you don't need it, right? It's in everyone's best interest not to dilute the founders unnecessarily. Reason being is, the investor needs you to be incentivized the same way you need your co-founder to be incentivized.

You need to still own a piece of the pie that's worth waking up and running this company, because that's what they want.

Eric Weiner: It benefits no one to do the recap.

Laura Cicirelli: Exactly.

Eric Weiner: No one. And we'll say that in our experience, and Laura, I think you probably share this with me, this is always open to conversations. Most of the people that are in this community, that we deal with, that other people in the community deal with, whether it's the founder or the investor... are reasonable.

Laura Cicirelli: Sensible, that's the way it is.

Eric Weiner: That's one of the great things about ECVC and working with startups and venture capital.

It's a partnership-based business and industry.

Laura Cicirelli: Not adversarial. People think it is. It's not.

Eric Weiner: And don't be afraid to have a conversation about reasonable things.

Laura Cicirelli: Yeah. Absolutely right.

Eric Weiner: Thank you so much for joining us for *The Founders Hour*. If you enjoyed this episode, be sure to subscribe on Apple Podcasts, Spotify, YouTube, or wherever you listen so you don't miss future conversations. If you would like to join the founders, our events live in our New York office. You can contact TheFoundersHour@Lowenstein.com for details.

You can also contact Laura or me. And next time, please join us for discussion on all the terms other than the economics that we discussed today. And believe it or not, those non-economic terms are as important, and sometimes more important, than economics and valuation in the deals that you're going to be doing. We look forward to having you join us then.