AN OVERVIEW OF PREFERRED STOCK

Preferred stock (like common stock) is a class of capital stock created under a company's certificate of incorporation (known as its charter) that typically entitles the holders to certain preferences and rights over the common stockholders. Preferred stock is a malleable tool for structuring investments. It enables companies to shape return on investment, investor rights, board composition and shareholder priorities.

AN OVERVIEW OF PREFERRED STOCK

The certificate of incorporation usually includes (whether in the initial charter or by subsequent amendment) provisions authorizing:

- Creation of preferred stock as a separate class of stock and authorization of a number of shares of preferred stock (with stockholder approval, if the certificate of incorporation must be amended to add the class).
- The board of directors to fix the number, designation and relative rights, preferences and limitations of each series of the preferred stock at any time. This "blank check" authorization allows the company's directors to issue preferred stock in any number of series and determine the rights of each series without needing additional stockholder approval.

Each series of preferred shares may have rights and preferences superior to those of other outstanding classes of stock. The various series are usually designated alphabetically: that is, series A, series B, series C and so on. Each series may also include in its designation one or more distinct characteristics, such as "convertible," "redeemable" or "senior."

The specific terms of a series of preferred stock are set out in a company's certificate of incorporation or, as in Delaware and certain other states, in a separate certificate of designation of preferred stock that is deemed to be an amendment to the company's charter.

The main features of preferred stock are: dividend payment preferences, liquidation preferences, redemption rights, voting powers, conversion rights, pre-emptive (first refusal) rights, and ranking within capital structure.

There are two primary objectives for an investment in preferred stock:

- Fixed income returns and a more stable value than common stock. This is frequently more common for an investment in public companies, in which case investors typically favor dividend-paying preferred stock.
- Capital appreciation with down-side protection superior to common stock. This is frequently more common for venture capital investments, in which case investors typically favor convertible preferred stock.

Preferred stock offers a company and its investors flexibility in structuring an arrangement that provides the company with needed capital for varying periods of time, while also providing investors a fixed minimum return and a chance to share in the upside if the company is successful. Circumstances, objectives and the parties' concerns vary from case to case, and the parties must make trade-offs and accommodations within the various investment characteristics described above to achieve their respective objectives and priorities.

NUMBER OF SHARES

The number of shares of a specific series of preferred stock, together with any other designated series, must be within the total number of authorized shares of preferred stock. Within that limitation, the number of shares in a series may be increased or decreased (but not below the number of outstanding shares of the series) by the company's board of directors, subject to a vote of holders of any outstanding shares of that series, if required. Shares redeemed or repurchased by the company may be cancelled and will then revert to either authorized but unissued shares of the specific series of preferred stock or, if desired, shares that are undesignated as to a series. This reversion must be specified in the certificate of designation for the specific series.

DIVIDEND PAYMENTS

Preferred stock may, but need not, provide for the payment of dividends. Issues relating to dividends include: the dividend rate, the form in which dividends will be paid, whether dividends will be cumulative or non-cumulative, and any restrictions on dividend payments.

The rate of dividends payable on each share of preferred stock can be stated as a fixed amount or a variable amount. Dividends are usually stated as a fixed percentage of the paid-in value (the initial purchase price or liquidation value of the stock), which is also a fixed dollar or percentage amount. However, dividends can also be paid at a floating rate, which may change according to a benchmark interest rate index or escalate from period to period. A floating dividend rate gives the company an incentive to redeem the shares as soon as possible.

Dividends may also be cumulative or non-cumulative:

- For cumulative preferred, if the company does not or cannot pay the dividends for any reason, those dividends accrue or accumulate over time until they are paid. The missed dividend payment is said to be in arrears. The company must pay accrued but unpaid dividends before it makes any other dividend payment.
- For non-cumulative preferred, if the company does not or cannot pay the dividends for any reason, the amount is lost and is not made up later. In this case, dividends are not paid at all if they cannot then be legally paid or if not declared by the board for the particular dividend period.

LIQUIDATION PREFERENCES

At a minimum, preferred stock is generally considered "preferred" in relation to a company's involuntary liquidation, dissolution or winding up of its affairs (together, liquidation). Before any distribution or payment can be made to the holders of common stock or any junior preferred stock, the holders of a series of preferred stock are entitled to be paid:

- The liquidation value (or liquidation preference) per share. The liquidation value is often stated as the purchase price the investor pays per share for the stock, or sometimes a multiple of the purchase price.
- All accrued accumulated dividends.

After the preferred stock liquidation preference is paid, the holders may be entitled to receive an additional liquidation payment, depending on whether the series of stock is participating or non-participating.

- If the preferred stock is non-participating, once payment is made in full to the holders of this series, the remaining assets and funds of the company are then distributed among the holders of the company's common stock and any junior preferred stock, according to their respective rights and preferences. The holders of the non-participating preferred stock do not receive any additional payments.
- For participating preferred stock, after payment of the liquidation preference to the preferred stockholders as described above, holders of the preferred stock series also participate on an as-converted-to-common stock basis in the remaining assets and funds along with the common stock. This is generally after payment of any liquidation preference payable to any junior preferred stockholders. Participating preferred stock also typically participates with the common stock in any dividend payments on an as-converted-to common stock basis.

If the liquidation of the company is voluntary, it may be deemed a redemption, in which case the holders of the preferred stock series may be entitled to receive the redemption price in effect at the time of the distribution, instead of the liquidation value, together with accrued accumulated dividends.

REDEMPTION RIGHTS

Preferred stock may, but need not, be redeemable. Non-redeemable preferred stock may be thought of as perpetual. Preferred stock may be redeemable but only at certain times or on the occurrence of certain delineated events.

Key redemption issues include: whether redemption is mandatory or optional; whether the redemption price is fixed or floating; whether or to what extent a premium will be required; when optional redemption will be available. This may be tied to specified redemption dates, performance milestones or stock price triggers; and, how many shares are to be redeemed.

Investors may require a company to redeem shares of preferred stock in cash at a certain time or on the occurrence of certain events. This requirement is typically referred to as mandatory redemption. The mandatory redemption price may be at a fixed or floating redemption price per share, and will include payment of accrued and unpaid dividends. Mandatory redemption can occur on one or more fixed or determinable future dates (like a debt security's principal amortization schedule or maturity date). In addition, investors may also require a company to redeem their preferred stock under certain circumstances, such as if there is a change of control of the company or a voluntary liquidation of the company.

The company may have the right to redeem the preferred stock at various times over a given period at specified redemption prices. This requirement is typically referred to as optional redemption. Often the redemption price is expressed as a percentage of the liquidation value of the stock which decreases over a period of time after the date of issuance (typically three to five years). At the beginning of the period, the redemption price is typically 100% plus a premium, which declines over each year in the period until there is no premium if redeemed more than a certain number of years after the date of issuance. At any redemption date, the redemption payment must include any accrued and unpaid dividends.

The following is an example of this type of optional redemption provision: (a) for the first three years after issuance, optional redemption is not permitted; and (b) beginning on the third anniversary of the issuance date, the company is permitted to redeem the preferred stock at the following prices: [FIRST YEAR OF PERIOD]107%; [SECOND YEAR OF PERIOD]105.5%; [THIRD YEAR OF PERIOD]102.25%; and [FOURTH YEAR] and thereafter 100%.

VOTING POWER

Preferred stock may, but need not, have voting rights. Voting preferred stock can have one of the following options: full voting rights, similar to common stock or voting rights only for certain events, such as a change in control or the issuance of other classes of preferred stock or shares of the same series.

Other voting issues include whether preferred stock:

- Carries a fixed number of votes per share or has a variable number of votes per share. For example, a variable voting provision may provide the following: "the number of votes entitled to be cast by the holders of the series A preferred stock equals that number of votes that, together with votes otherwise entitled to be cast by the holders of the series A preferred stock at a meeting, whether by virtue of stock ownership, proxies, voting trust agreements or otherwise, entitle the holders to exercise one vote more than one-half of all votes entitled to be cast."
- Votes as a separate class or together as one class with the common stock (with preferred shares counted on an as-converted basis, as applicable) on all matters on which stockholders are entitled to vote.

SPECIAL EVENTS

Holders of preferred stock may have separate protective voting rights that arise only if certain extraordinary corporate actions occur. These may be in addition to ordinary voting rights or the only voting rights offered to preferred stockholders.

Often, the affirmative vote of at least a majority or two-thirds of the outstanding preferred stock is required to:

- Amend or repeal any provision in a company's charter or by-laws that adversely affects the voting powers, rights or preferences of the specific series of preferred stock.
- Authorize or create any stock of any class or series ranking senior to or on an equal level with the specific series of preferred stock in the distribution of assets on any liquidation of the company or in the payment of dividends.
- Merge or consolidate the company with and into any other company, unless the resulting company will have no class of stock or other securities ranking senior to or on parity with the specific series of preferred stock.
- Purchase or redeem any shares of any series of stock ranking junior or on parity with the specific series of preferred stock unless the full dividend on all shares of that series of preferred stock has been paid.
- Authorize or take other company action which would be considered adverse or prejudicial to the interests of the preferred stockholders.

BOARD REPRESENTATION

Investors making significant preferred stock investments sometimes seek board representation. This is more typical for earlier stage financings. Holders of preferred stock, voting as a separate class, may have the right to elect a specific number of directors. However, investors in a public company may have valid reasons for refusing board representation to maintain their independence from the company. A director appointed by preferred stockholders may be deemed the representative of those investors. As a result, communications between the director and the investors could be deemed to:

- Violate fiduciary duties that a director of a company owes to all stockholders.
- Transmit confidential information, which would prevent the investors from trading in the company's stock or risk insider trading violations.

However, preferred stock investors may be granted a springing right to appoint additional directors if the company misses a number of consecutive or non-consecutive dividend payments or fails to timely redeem shares according to any mandatory redemption or sinking fund obligation.

CONVERSION RIGHTS

Preferred stock may, but need not, be convertible. Conversion is a negotiated right. Key conversion issues include whether: the conversion rate is fixed or floating; the conversion rate is adjusted and, if so, how; conversion is optional or mandatory; and a sufficient number of shares of common stock is reserved for conversion.

Preferred stock may be structured as being convertible into shares of a company's common stock (or even other securities) based on a specified conversion rate or formula. The conversion ratio can be either a:

- Fixed price per share, which is established in the certificate of designation based on the initial purchase price.
- Floating rate, which is set in relation to the market price of the underlying common stock (usually after applying a conversion discount) at the time of conversion. This is typical for public companies.

If the conversion price represents a discount to the market price on the date of issuance of the preferred stock, the preferred stock may be deemed to have a "beneficial conversion feature" for accounting purposes. This would require a company to record a deemed dividend on the preferred stock equal to the amount of proceeds attributed to the issuance of preferred stock less the quoted market value of the common stock issuable on conversion.

Often the preferred stock includes anti-dilution adjustments, which provide for changes in the conversion price or conversion ratio if certain events or circumstances occur, such as dilutive stock issuances, stock splits and combinations. For example, the certificate of designation may provide that the conversion price or conversion ratio is decreased if either:

- The company sells another equity or equity-linked security at a price per share lower than the initial conversion price or the then-current market price.
- The market price of the underlying shares of common stock falls below a stated price for a specified period of time.

Conversion, when at the holder's option, may occur in whole or in part, immediately or at some later date, after the issuance of the preferred stock. On the other hand, the company may want the right to force preferred stockholders to convert their shares into common stock if certain events occur.

For privately-held companies, often their preferred stock certificate of designation will provide for automatic conversion of all outstanding preferred shares to common stock upon the closing of an underwritten initial public offering (IPO) if certain conditions are met, such as the offering being completed at or above a pre-determined public offering price or market capitalization and attaining a minimum level of gross proceeds for the company.

The company must always have reserved the full number of shares of common stock potentially issuable on the conversion of the outstanding preferred stock. This must be reserved out of the company's authorized but unissued common stock. When issued on conversion of the preferred stock, the shares of common stock should be considered validly issued, fully paid and nonassessable.

PRE-EMPTIVE RIGHTS

Earlier stage financing transactions often provide investors with pre-emptive (or first refusal) rights to preserve the investors' proportional share of the company as it continues to raise growth capital. These rights typically provide that, if the company issues equity securities in a subsequent financing transaction, the preferred stockholders can buy enough new securities to maintain their existing ownership percentage in the company, calculated on a fully diluted basis.

The purchases will be on the same terms and conditions as those offered to participants in that financing. If preferred stockholders elect not to exercise their pre-emptive rights or are unable to do so because registration under the Securities Act would be required but cannot be completed in time, their equity interests would be diluted proportionately as a result of completion of the financing transaction.

Pre-emptive rights can last for a fixed period of time or even remain open-ended, but almost always terminate immediately before a company's IPO. Pre-emptive rights are not usually transferable and do not usually survive after the preferred stock is converted, exchanged or redeemed.

Investors should negotiate for their pre-emptive rights to be included as a provision in a company's certificate of designation or certificate of incorporation rather than as a covenant in the securities purchase agreement. Any violation of these rights would constitute a violation of the company's charter, which is more serious than a breach of contract.

RANKING WITHIN THE CAPITAL STRUCTURE

Preferred stock ranks senior to all classes of common stock in the payment of dividends and the distribution of assets on any liquidation of the company. The company and its investors must decide whether a particular series of preferred stock ranks junior or senior to, or on parity with, other existing or future authorized series of preferred stock. From the perspective of dividends, if a company has only enough available funds to meet the dividend schedule for one series of preferred stock, only the most senior series will receive a dividend payment.

However, preferred stockholders' claims are still subordinate to those of the company's bondholders and other creditors, regardless of its preferred status within a company's capital structure.