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CORPORATE LAW

Protecting a Capital Investment

Basic characteristics of preferred stock in angel and venture capital financing

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Start-up and growing companies invariably need additional financing beyond the financial capabilities of their founders. These companies, which often do not have proven track records, may find it difficult to obtain bank financing. As a result, after they exhaust the finances of their founders, families and friends, they typically turn to outside investors; first angel investors and then venture capitalists.

Angel investors typically make investments up to $1 million in such companies, whereas venture capitalists make investments over $1 million. These investments are made in exchange for equity ownership in the companies. Investors typically receive preferred stock rather than common stock in the companies. The primary reason for the use of preferred stock is because the investors want to protect their investment by having preferential rights over the common stockholders. See Gregory C. Smith, *Start-up and Emerging Companies* § 9A.02 (Law Journal Press 2005).

It is important to know what is being given to investors in exchange for their cash infusion. This article explains several basic characteristics of preferred stock, which has certain rights, privileges and preferences over common stock, including a) dividend preferences, b) liquidation preferences, c) conversion rights, d) anti-dilution protection, and e) voting rights.

Preferred stock is usually given a dividend preference over common stock. This means that dividends must be paid to preferred stock before they can be paid to common stock. Dividends may be discretionary or mandatory and cumulative or noncumulative.

Discretionary vs. mandatory dividends. A discretionary dividend means that the company is not required to pay a dividend to the preferred stock. A mandatory dividend is similar to an interest component of corporate debt because the company must set aside and pay dividends to the preferred stock at a specified rate.

Event Anti-Dilution Protection			
Before 2 for 1 C/S split		**After 2 for 1 C/S split**	
200,000 C/S	66.6%	400,000 C/S	80%
100,000 P/S	33.3%	100,000 P/S	20%
300,000 sh	100.0%	500,000 sh	100%
Without some anti-dilution protection, the preferred stockholders' percentage ownership of the company would decrease from 33.33 percent before the common stock 2 for 1 stock split to 20 percent after the stock split.			

Cumulative vs. noncumulative dividends. A dividend preference may also be cumulative or noncumulative. Simply stated, with a cumulative dividend, declared but unpaid dividends accrue and must eventually be paid to the preferred stock. A noncumulative dividend does not accrue; rather, it ceases to exist if it is not paid.

The preferred stock of such companies usually provides for noncumulative discretionary dividends. The reason is that these companies usually do not generate enough cash to pay dividends and any payment of dividends may adversely affect the company's cash flow. If the company paid dividends, the investment capital paid by the preferred stock would be paid back to the investors, thereby requiring future

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investment capital. Investors realize the illogic of such an approach and expect to receive preferred stock with noncumulative dividends declared at the discretion of the company. See Fenwick & West, *Venture Capital for High Technology Companies* (2002); Smith at §§ 8.02[3][c], 9A.03[2].

Upon the liquidation of a company, the preferred stock has the right to receive a fixed amount of money before assets are distributed to the common stock. The amount is typically the preferred stock investment plus any accrued but unpaid dividends. A liquidation preference may also be triggered by events other than liquidation, such as a merger or a sale of assets, commonly known as a "deemed liquidation."

Preferred stock investors may want to receive a premium in addition to their investment, which may be described as a percentage (e.g., 10 percent annually of initial investment) or a multiple (e.g., 2x initial investment). The preferred stock may also participate with the common stock in the distribution of any assets remaining after the payment of the liquidation preference to the preferred stock. This may be full participation, or limited participation through the use of a cap. See Fenwick at 13; Smith at § 8.02[3][d].

Generally, preferred stock is convertible into common stock at the option of the preferred stockholder and is often automatically converted into common stock upon an initial public offering (IPO) or other triggering events. See Wade H. Stribling, "Preparing a Company for Financing and Evaluating Financing Alternatives," *Doing Deals 2003: Understanding the Nuts & Bolts of Transactional Practice in an Uncertain Market* (PLI), available on Westlaw at 1357 PLI/Corp 691.

Optional conversion. The preferred stock is usually convertible into common stock at the preferred stockholder's option at any time. The preferred stockholders seldom convert their shares into common stock because they would lose the rights, privileges and preferences associated with preferred stock. However, they will convert their preferred stock into common stock if there is greater participation with common stock upon liquidation or a deemed liquidation, such as a merger. See Smith at § 8.02[3][e][i].

Mandatory conversion. The preferred stock will typically also include mandatory or automatic conversion rights upon an IPO of the company or upon the majority vote of the preferred stockholders. However, not all IPOs will trigger such an automatic conversion. Instead, the IPO must meet certain qualifications or criteria, such as a minimum offering size, measured by proceeds, and a minimum price per share.

The reason for the qualifications is that the preferred stockholders do not want to be forced to convert their preferred stock into common stock upon a small IPO because they will lose the rights, privileges and preferences of preferred stock. A minimum price per share ensures that preferred stock will not convert into common stock unless they will receive a certain return on their investment.

The reason for automatic conversion is that it may be very difficult to do an IPO if preferred stock will remain outstanding after an IPO because new investors will not want to buy common stock if prior investors will continue to

Full Ratchet Anti-Dilution Provision

The company has common stock and Series A preferred stock:

C/S = 1,000,000 sh	
Series A P/S ($1.00/sh) = 1,000,000 sh	with 1:1 conversion rate
Total = 2,000,000 sh	

The company issues 2,000,000 shares of Series B P/S at $.50 per share. Instead of a 1:1 conversion rate, the Series A preferred stock now has a 2:1 conversion rate because the conversion rate "ratchets down" to take into account the lower price of $.50 per share. As a result, the Series A preferred stock is entitled to convert into 2,000,000 shares instead of 1,000,000 shares, as follows:

Before Series B	After Series B
1,000,000 x ($1.00/$1.00) = 1,000,000 sh or 1:1 conversion rate	1,000,000 x ($1.00/$.50) = 2,000,000 sh or 2:1 conversion rate

Weighted Average Anti-Dilution Provision

(same facts as above)

C/S = 1,000,000 sh	$1.00/sh	$1,000,000
Series A P/S = 1,000,000 sh	$1.00/sh	1,000,000
Series B P/S = 2,000,000 sh	$.50/sh	1,000,000
Total = 4,000,000 sh	Avg = $.75/sh	$3,000,000

Instead of a 1:1 conversion rate, the Series A preferred stock now has a 1.333 conversion rate (1,000,000/.75 = 1,333,333, then 1,333,333/1,000,000 = 1.333) because the conversion takes into account the average price of all equity investments. As a result, the Series A preferred stock is entitled to convert into 1,333,333 shares of common stock instead of 1,000,000 shares. Obviously, the weighted average method is more forgiving to the company than the full ratchet method where the Series A preferred stock would have been able to covert into 2,000,000 shares of common stock.

have the preferences provided by preferred stock.

Preferred stock typically is converted into common stock on a one-for-one basis, subject to adjustment for stock splits and similar events. The conversion ratio is generally adjusted if the company later issues additional stock at a price less than the price paid by the preferred investors ("price anti-dilution protection"). See Ellen B. Corenswet, "Formation and Financing of Start-Ups," *Venture Capital 2004: Venture Creation, Management & Financing in the New "Post-Bubble" Market* (PLI), available on Westlaw at 1457 PLI/Corp 653; Smith at §§ 8.02[3][e], 9A.03[5][b].

Preferred stock typically contains provisions protecting preferred stock holders from dilution of their percentage ownership interest from such events as stock splits and stock dividends (i.e., event protection), as well as against future sales of stock at lower prices (i.e., price protection).

Event anti-dilution protection. Event protection protects preferred stock when the number of shares of common stock is increased through stock splits or stock dividends. This type of anti-dilution protection preserves the preferred stockholders' percentage ownership in the company in relation to the common stock. See the accompanying "Event Anti-Dilution Protection" chart.

Price anti-dilution protection. In addition, preferred stock typically includes anti-dilution protections against future sales of stock at lower prices. These provisions are usually "weighted-average" formulas, in which the increase in the conversion ratio takes into account the relative amounts of stock sold at various prices. However, on occasion, the anti-dilution protection may be a "full ratchet," in which the conversion ratio is automatically adjusted to the price of the most recently issued lower priced stock, regardless of the number of shares issued. See the accompanying "Full Ratchet" and "Weighted-Average" chart. See Mark A. Medearis and Michael W. Hall, "Minority Equity Investments in Connection with Strategic Alliances," *Structuring, Negotiating & Implementing Strategic Alliances 2006* (PLI), available on Westlaw at 1551 PLI/Corp 29. For more information on anti-dilution price protection, see Stribling (comprehensive explanation of "full ratchet" versus "weighted average" provisions); David A. Broadwin, "An Introduction to Antidilution Provisions," *The Practical Lawyer* (2004).

Preferred stock typically votes with the common stock as if the preferred stock were converted into common stock, commonly known as an "as-converted" basis. In addition, preferred stock may be given the right to elect a certain number of directors. Also, corporate statutes provide preferred stock with special class voting rights upon the occurrence of certain significant transactions and extraordinary events, such as a merger or an amendment to the company's certificate of incorporation. See Fenwick at 15; Smith at § 8.02[3][h].

Founders of start-up companies need to know what they are giving up when they issue preferred stock to angel and venture capital investors in exchange for their cash. As explained, these investors typically receive dividend and liquidation preferences, conversion and voting rights, and anti-dilution protection. ■