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www.hflawreport.com Volume 6, Number 48 December 19, 2013

# Convertible Preferred Stock

## Convertible Preferred Stock: How Preferred Is It? (Part One of Two)

By William Q. Orbe, Thao H.V. Do and Catherine Rossouw, *Richards Kibbe & Orbe LLP*

Growth investors, including hedge funds, often leave value on the table when negotiating for investments in convertible preferred stock, which is the equity security of choice for investing in emerging growth companies. Convertible preferred stock provides growth investors with two benefits. The first is a feature of preferred stock that distinguishes it from common stock: a liquidation preference that is payable in priority to common stock if the company is sold or liquidates. The second benefit of convertible preferred stock is what distinguishes it from straight preferred: the right to convert the investment into common stock. This is a valuable right if the company does well enough for its common equity value to increase significantly.

In theory, these twin attributes of convertible preferred stock – enabling the investor to reduce the risk of loss and participate in upside appreciation – make convertible preferred a uniquely attractive investment tool. Unfortunately, though, that attractiveness can be diminished by defects or gaps in the security's documentation. In particular, we regularly see three value-sabotaging flaws in supposedly "standard" convertible preferred terms. These are provisions that: (i) enable the company to leak value to the common stock while the convertible preferred remains outstanding; (ii) force conversion to occur sooner than the investor might like; and (iii) allow the preferred investor's bargained-for terms to be amended away. These flaws are of particular concern to late round investors, who often acquire their convertible preferred stock at significantly higher prices than earlier round investors.

Since most convertible preferred financings start off with a term sheet, a prospective investor should have an opportunity to identify any of the above risks and propose solutions to them before the specific charter provisions for the series are adopted. With this in mind, this two-part article series provides a roadmap with respect to such risks and provides recommendations to fully capture the benefits of convertible preferred stock investments through effective negotiation of term sheets. Identifying and heading off value-compromising documentation problems at the term-sheet phase require alertness and attention to detail, but the effort is well worth making. The alternative is spending investment capital on convertible preferred stock that may not be quite as preferred as it seems.

More specifically, this article series addresses the four main areas of a company's charter where the potential for value leakage, premature conversion or the loss of rights via amendment is most acute: namely, the provisions governing dividends, liquidation preferences, conversions and amendments. This first article addresses charter provisions governing dividends. The second article will cover charter provisions governing liquidation preferences, conversions and amendments.

### *Dividends*

The typical emerging growth company does not intend to pay regular cash dividends because whatever cash the company raises or generates is typically more profitably

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www.hflawreport.com Volume 6, Number 48 December 19, 2013

reinvested in the business than distributed to stockholders. Consequently, the charter usually will provide that dividends are paid on the preferred only "when and if declared by the board" and that dividends are not cumulative. The charter generally also says that no dividends may be paid on the common until all dividends declared on the convertible preferred have been paid. The latter provision sounds good, as it seems to recognize the relative priority of the convertible preferred in the event that any dividends are in fact to be paid.

On closer examination, however, the standard bar on common dividends when preferred dividends remain unpaid may provide only illusory protection. That is because (assuming dividends are not cumulative under the charter) a preferred dividend can be outstanding only if the board has chosen to declare it in the first place. In reality, then, there is nothing to prevent the company from ignoring the thought of a preferred dividend and beginning to pay dividends on the common. If the company takes that path, enterprise value that the preferred holder might have thought was accreting to its eventual benefit is being prematurely leaked to the common holders.

While no one should expect the company actually to pay cash dividends on the convertible preferred, it is critical that preferred stockholders have the power to limit the leakage of value away from them. There are three charter clauses that a convertible preferred holder can attempt to negotiate in order to obtain this power. These are clauses that: (i) give the preferred stockholders a veto over proposed dividends on the common stock; (ii) provide cumulative dividends on the convertible preferred stock; or (iii) grant the convertible preferred stock the right to "participate" in any dividends paid on the common stock.

## *Veto Rights*

### Veto over Dividends on the Common Stock

The most common way for preferred investors to protect themselves from value leakage is to insist on a veto right over the payment of dividends on (or redemptions of) the common stock. A veto right is a direct and important tool to fight leakage. That said, its value to any particular preferred investor will hinge on who controls the veto's exercise.

### Individual Veto

The ideal form of common dividend veto right is one granted to the particular investor rather than to a class or series of preferred stockholders. However, unless the investor is supplying a particularly large amount of capital to the company or otherwise has extraordinary negotiating leverage, acquiring an individualized veto right is an unlikely achievement.

### Class-Level Veto

The next best veto right over common dividends is a veto granted to the particular series of preferred the investor holds. This type of veto is generally quite beneficial. But, to understand the true degree of protection it will provide, the preferred investor must attempt to analyze the extent to which all holders of the series are (or aren't) aligned in their overall economic interests. Divergent economic interests within the series may mean that a particular investor cannot count on the veto right being exercised for its benefit. For example, imagine two investors in the same late-round series of preferred. The first investor holds only those late-round shares; the second investor holds in addition a significant position in the common stock and/or a large number of preferred shares of an earlier, lower-priced series. While the

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www.hflawreport.com Volume 6, Number 48 December 19, 2013

first investor may be horrified by the idea of a dividend on the common and keen to see the veto invoked, the second investor might in fact fare better by allowing the dividend and therefore would not vote for the veto's exercise.

The foregoing is not meant to dismiss the benefit of a series-level veto on common dividends; on the contrary, it is a generally useful protection and worth fighting for. It is merely to say that an understanding of varying incentives among the class members is important to assessing how beneficial the series-level veto may turn out to be from the practical perspective of any particular investor.

## Veto by All Preferred Voting as a Single Class

The least protective form of common dividend veto right – and the one most likely to be offered up by the company when investors ask for a veto to be added to the charter – is one exercisable by all preferred shareholders voting together as a single class. This is a flimsy right. It is nearly certain that the different rounds of preferred investors brought together for the vote will have strongly diverging economic interests. As a result, no particular investor can feel confident, in the abstract, that the veto will be used to prevent a common dividend to which that investor objects. An investor that asks the company for a veto right and is offered the "single-class" version in response should push for one of the other two flavors of veto described above.

Growing young companies worry about giving preferred investors any type of veto rights that could limit the company's flexibility down the road. That is a legitimate corporate concern. But preferred investors have a sound argument to push back when the company resists granting a veto, or offers only a watered-down "single-class" form of veto. Emerging companies simply should not be paying dividends on their common stock, and a fair veto right is one way for preferred investors to make sure that value leakage doesn't happen.

### *Cumulative Dividends on the Convertible Preferred*

Cumulative dividends are preferred dividends that accrue at a stated rate regardless of whether any dividends are actually "declared by the board." While a charter term providing for cumulative dividends is not terribly common, the concept may be worth arguing for because it protects preferred holders in two ways.

First, recall that the standard charter says dividends may be paid on the common only after any dividends owing to (i.e., already declared on) the preferred have been paid, which means that the board, simply by refraining from declaring any preferred dividends, is free to send cash to the common whenever it wants. The cumulative feature (if properly drafted) closes this avenue for value leakage by requiring that the preferred receive all of its accrued dividends before the common can be paid – the need for a board declaration is taken out of the picture. Thus, if the company has insufficient cash to pay both the accumulated dividend on the preferred and a dividend on the common, a common dividend and its attendant value leakage are not going to happen.

In addition to preventing ongoing value leakage to the common, a cumulative dividend provision can protect preferred holders against leakage when a liquidation (or sale) of the company occurs. This protection can be achieved by adding accrued dividends to the liquidation preference of the preferred. Over time, this increases the amount that must be paid to the preferred in a liquidation (or sale) before the common can share in any proceeds from that event. To the extent the investor convinces the company to adopt the cumulative dividend feature, flowing accrued dividends into the preferred liquidation preference should be part of the package.

Companies generally resist a cumulative dividend provision on the basis that it will result, over time, in the preferred building up of stored value at the expense of the common. If the company has granted the preferred a veto right as discussed above, the company also will argue that the preferred thereby has gotten all the leakage protection it needs. However, if the business deal is that the preferred investor is to receive an increasing minimum return before any value is allowed to the common, the preferred investor is well within its rights to insist on a cumulative dividend.

### *Right to Participate in Common Dividends*

Besides veto rights and a cumulative dividend provision, another way to address the risk of value leakage is to make the convertible preferred stock "participating."

Normal convertible preferred stock is entitled only to dividends specifically declared thereon. By contrast, participating convertible preferred stock, as it relates to dividends, is stock which is entitled to participate (on an as-converted-into-common-stock basis) with the common stock in any dividends that are paid on the common, often in addition to receiving any declared preferred dividends. Investors should keep in mind that participating convertible preferred stock receives its share of the dividend pool in parity with the common stock, and therefore, a dividend participation right is not as protective as holding a veto over the payment of dividends to the common – that is, a participation right alone does nothing to hinder the board in distributing cash to the common. However, if the preferred makes up a large portion of the stock entitled to participate in the dividend, the investor may be satisfied that the preferred stock will capture a sufficient level of value when any dividend is declared on the common stock.

A particular virtue of a participation feature is that it may spare a convertible preferred investor a difficult choice if the company plans to make a significant dividend on the common stock. Without a participation right, a convertible preferred holder that wishes to receive a share of that cash distribution must exercise its conversion right and obtain common stock. By converting, however, the preferred stockholder will be abandoning the downside protection provided by the preferred liquidation preference, as well as any other protective features unique to the preferred stock (e.g., class-specific voting rights). If an investor cannot negotiate participating status for its convertible preferred, obtaining the dividend veto and/or cumulative dividend rights described above becomes all the more important.

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www.hflawreport.com Volume 7, Number 1 January 9, 2014

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## Convertible Preferred Stock: How Preferred Is It? (Part Two of Two)

By William Q. Orbe, Thao H.V. Do and Catherine Rossouw, *Richards Kibbe & Orbe LLP*

Convertible preferred stock investments provide important benefits for hedge funds and other investors including, among other things, a liquidation preference and the right to convert the investment into common stock of the company. Nonetheless, an investor's failure to rigorously negotiate a term sheet with respect to a convertible preferred stock investment before the specific charter provisions for the series are adopted can lead to inclusion of benefit-sabotaging terms that (i) enable the company to leak value to the common stock while the convertible preferred remains outstanding; (ii) force conversion to occur sooner than the investor might like; and (iii) allow the preferred investor's bargained-for terms to be amended away. There are four principal areas of a company's charter where the potential for value leakage, premature conversion or the loss of rights via amendment is most acute, namely: the provisions governing dividends, liquidation preferences, conversions and amendments. This two-part series identifies these risks and provides recommendations to assist investors in negotiating convertible preferred term sheets to fully capture the benefits of such investments. This second installment will cover the charter provisions governing liquidation preferences, conversions and amendments while the first installment addressed the charter provisions governing dividends. See "Convertible Preferred Stock: How Preferred Is It? (Part One of Two)," The Hedge Fund Law Report, Vol. 6, No. 48 (Dec. 19, 2013).

### *Liquidation Preferences*

Convertible preferred stock usually receives a "liquidation preference" upon the liquidation, dissolution or winding up of the company or in connection with a "deemed liquidation event." The liquidation preference prioritizes how the proceeds from the event are shared among the classes of stock. Convertible preferred stock typically receives a predetermined liquidation preference beforeany payments are made to the common stock. For some companies, later series of convertible preferred stock will receive proceeds before all earlier series. Typically, the liquidation preference assigned to any series of convertible preferred stock is the original share purchase price plus any accrued dividends. For preferred issued in a "down round," the liquidation preference may be a multiple of the original share purchase price.

The terms of the liquidation preference are therefore a major aspect of the convertible preferred holder's ability to prevent value leakage to the common or earlier series of preferred. Apart from the amount of the liquidation preference per se, the key points to focus on in the liquidation preference section of the charter are: (i) the events triggering the right to receive the liquidation preference; (ii) the vote needed to waive the effect of a deemed liquidation event; and (iii) whether the liquidation preference is "participating" or "non-participating."

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www.hflawreport.com Volume 7, Number 1 January 9, 2014

### *Deemed Liquidation Events*

If the preferred holder's right to receive its liquidation preference were triggered only by the actual liquidation, dissolution or winding up of the company, any other liquidity-generating corporate event – such as a sale of the company – would present the preferred holder with a potentially difficult choice. The holder could convert into common in order to receive a portion of the transaction proceeds; but that would mean giving up the preferred liquidation preference (which might in fact exceed the investor's ratable share of the transaction proceeds). Alternatively, the investor could refrain from converting in order to retain the liquidation preference; but that would mean foregoing transaction proceeds.

A preferred investor can avoid this potential dilemma by insisting that the liquidation preference be triggered by certain liquidity events occurring outside the realm of liquidation, dissolution or winding up. This is achieved by inserting in the charter the concept of "deemed liquidation events," such as a merger or business combination, a sale of the company or a sale of substantially all the company's assets. The concept of deemed liquidation events is customary, but occasionally companies attempt to construct the definition more narrowly than warranted. Investors therefore should review this provision carefully to make sure it is sufficiently comprehensive.

### *Waiver of Deemed Liquidation*

An emerging growth company's charter generally provides that the preferred stockholders may vote to waive their right to receive a liquidation preference in connection with a deemed liquidation event. As discussed above in relation to dividends, investors should carefully consider who will control this vote. In particular, investors should examine the respective interests of the preferred holders to see how well their interests are aligned. Interests diverge where investors have different convertible preferred stock purchase prices (and therefore different liquidation preferences and conversion prices). It may be in the interest of an early round investor with a low liquidation preference and conversion price to vote to waive the liquidation preference for all preferred, thereby allowing more value to flow to the common (and the preferred that converts into common). The most protective provision gives each investor the right to decide whether or not to waive the liquidation preference, but this is not typical. The next best protection is a series-by-series vote. The weakest protection is a provision that allows all the preferred series to vote together as a single class on an as-converted basis.

### *Participating or Non-Participating Liquidation Preference*

Once the convertible preferred investor has ensured that the charter includes the concept of deemed liquidation event and acceptable arrangements governing related waivers, a third issue arises: whether the liquidation preference will be "participating."

A non-participatingliquidation preference – which the company is likely to propose in the initial term sheet – confronts the preferred investor with a binary choice in the case of a liquidation event. The investor either can collect its liquidation preference or convert to common stock and collect its share of the liquidation proceeds alongside the other common stockholders.

By contrast, a participatingliquidation preference gives the investor both its liquidation preference (which is paid out

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www.hflawreport.com Volume 7, Number 1 January 9, 2014

before the common stockholders receive any proceeds) and a share of the remaining liquidation proceeds (paid alongside the common stock and the other participating preferred stockholders). In this respect, a participating liquidation preference is similar to an investment in a private equity fund where a limited partner receives the amount of its initial investment – often with a return – and then splits the remaining upside with the fund sponsor. This economic arrangement is generally not the investment understanding between the investor and an emerging growth company, but when it is, the investor should receive a participating liquidation preference in order to capture its agreed share of the value.

## *Conversions*

Thus far, we've been discussing sections of the company's charter that present the potential for value leakage, and the various provisions a convertible preferred investor may negotiate to protect itself from that risk. A separate type of risk against which the investor must seek charter protection is the prospect of conversion from preferred into common sooner than the investor wants.

Convertible preferred stock usually contemplates both voluntary and mandatory conversion into common stock. The major risk for the investor is being converted mandatorily at a time when the investor does not wish to part with the rights and protections afforded to the preferred stock. The charter typically requires mandatory conversion upon (i) the consummation of a "Qualified Initial Public Offering" or (ii) the vote of a specified majority of the preferred stockholders, whichever happens first. The investor should focus on these provisions in an attempt to limit the potential for premature conversion.

### *Qualified IPO*

For an initial public offering to be a "Qualified Initial Public Offering," and thereby trigger mandatory conversion of the preferred, the charter typically requires both a minimum price per share and a minimum amount of proceeds to be received by the company. It is important that both of these conditions are included in the definition. The "minimum price per share" ensures that investors realize an acceptable return on their investment in connection with the mandatory conversion of their preferred. The "minimum amount of proceeds to the company" ensures that enough stock is sold to the public so that there will be significant float and trading volume to make the stock relatively liquid – it is difficult and time consuming for an investor to sell a significant quantity of common stock into a thinly-traded market.

### *Stockholder Vote to Convert*

Company charters routinely provide that preferred stock will convert automatically into common stock upon a specified shareholder vote. As discussed above in relation to dividends and waivers of the liquidation preference, investors should carefully consider who will control any vote to convert their particular preferred into common. Once again, the interests of holders of different series of preferred will not be aligned. Holders of lower liquidation preference shares may receive more value in a sale or IPO if they force higher liquidation preference preferred stock to be converted before the sale or IPO. To avoid being forced to convert prematurely, an investor should make sure there is a series-by-series vote required for automatic conversion – not a vote of all preferred voting together as one class.

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www.hflawreport.com Volume 7, Number 1 January 9, 2014

## *Amendments to the Preferred Terms*

A final area of concern is what the charter says about amendments to the terms of the convertible preferred stock. The goal here is to ensure that the amendment process cannot be used unduly to disrupt the preferred terms for which the investor has bargained. To protect itself, the investor must understand how the proposed amendment regime applies to both the investor's series of preferred and the other outstanding series.

### *Changes to Terms of the Investor's Series*

A typical charter provides that an amendment to terms of a particular series of preferred stock (e.g., reducing the liquidation preference or adjusting the conversion price) requires a vote of that series. Occasionally, however, a company attempts to say that amendments may be made to the terms of any preferred series by a vote of all preferred stockholders, voting together as a single class. An investor should resist this departure from the normal series-vote system; as discussed above, a holder of a particular series of convertible preferred stock may have very different economic interests than holders of the other series.

Alternatively, some company charters provide that amendments to the rights of any series of convertible preferred stock may be made by vote of all preferred voting as a single class, except that if any series of convertible preferred stock receives materially worse terms than the others, a separate vote of that more adversely affected series is required. Investors should reject this approach as well. All preferred holders voting together as a single class could amend the rights of all the series to have the same liquidation preference and, while this amendment might not result in one series receiving "materially worse terms" than the others, it clearly could affect adversely the series that had the higher liquidation preferences. Again, investors should insist on a standard series-level vote to alter the bargained-for terms of that series.

### *Changes to Terms of Other Series*

Ensuring that the charter requires a series-level vote on amendments is not the end of the bargain-protection story. Remember that changing the rights of another series can have the same negative impact on a particular series as amending that series itself. For example, increasing the liquidation preference on the Series A and Series B may have the same effect as reducing the liquidation preference on the Series C because it will result in the Series A and B shareholders taking a greater portion of any sale or liquidation proceeds. To address this risk, holders of a particular series should insist that: (i) any change to their series requires a majority vote of that series; and(ii) any change to another series that has an adverse impact on their series also requires a majority vote of their series.[1]

## *Conclusion*

Convertible preferred stock is highly customizable and it is important to closely examine the proposed terms to understand your options when negotiating key term sheet sections. Seemingly innocuous provisions or omissions can undermine the benefit of holding convertible preferred. In addition, investors need to study the company's capitalization table to understand the relative interests of the different stakeholders – different series may have widely diverging economic interests which can materially impact the voting dynamics. All consent rights should be viewed with this in mind and should be structured to make sure that any critical vote is controlled by those with aligned interests. By being vigilant at the term sheet negotiation stage, an investor should be able to secure preferred stock that truly is preferred.

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[1] The Delaware General Corporation Law (Section 242(b)(2)) offers some protection to holders of convertible preferred stock by entitling the holders of a particular class to vote as a class on any proposed charter amendment that would "change the powers, preferences, or special rights of such class so as to affect them adversely." However, this provision may not adequately protect a series against the negative impact on that series resulting from changing another series.