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Start-Up Raising Capital?

Some Common Features of Preferred Shares & Why Some Select Preferred Shares over Convertible Debt

When you start a business and want to attract your first round of financing, Preferred Shares is one product that can be offered to Investors. Many Founders have asked us to explain exactly what Preferred Shares are and compare and contrast Preferred Shares to Convertible Debt. To this end, we have summarized some of the key features of Preferred Shares and included a discussion of why some may opt for one product over another.

1. What Are the Features of Preferred Shares?

Preferred shares are a form of equity ownership in a company and the shares have certain rights that are "preferred" to common shares. Some of these preferential rights include dividend payments, liquidation preferences (if company goes bankrupt preferred shareholders receive money back before common shareholders), voting rights (ability to vote on major events similar to the way common shareholders vote), conversion rights (ability to convert to common shares if some event happens) and preemptive rights (also called, anti-dilution clause - ability to stop the dilution of the percentage amount of your total company ownership).

Below is a summary of some of the key provisions that can be negotiated with investors when dealing with a preferred share:

Dividends: Preferred shares may include a fixed dividend payment and the rate that is offered (if any) is usually conveyed as a dividend rate. The company is free to add a dividend feature if they wish but often start-up companies do not have a sufficient cash flow to allow for these payments. As such, if included, dividend payments are either accrued and not paid or come in the form of additional shares. Preferred shares are often referred to as a quasi-debt instrument as the dividend feature is very similar to an interest rate on debt.

Liquidation Preference: If a company goes bankrupt, the investors & creditors (bond holders, equity holders, other debt holders) are lined up and given a liquidation order of payment preference. Preferred stock (hence the name Preferred) allows the preferred shares to rank senior to common stock if the company goes under for some reason. If this were to happen, before any distributions can be made to common stockholders, including founders, the holders of preferred stock are entitled to receive the per share liquidation value of their preferred shares and

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all unpaid accumulated dividends. Preferred shares are not however given liquidation preference to debt.

Voting Rights: Preferred shares may have voting rights that are similar to common shareholders. This voting can be narrow or broad and can for example grant voting rights to elect board members or voting rights on significant company decisions. These matters are usually referred to as "reserve matters" and include actions such as: (i) amending or repealing any provision in the company's charter or bylaws; (ii) authorizing the creation of any new class of stock; (iii) entity changes such as merge or consolidate the company with any other company; or (iv) take any action that may be considered prejudicial to the preferred stockholders.

Conversion Rights: Convertible debt always includes a conversion right and Preferred Shares can also include this feature. Usually this feature is structured such that the preferred shares convert into common stock at a specified price based on a trigger event or some specified event. The conversion for the stock will either be a mandatory or optional conversion depending on negotiations, however, more often than not we see mandatory conversion linking the conversion of the preferred shares to a specific trigger event. (eg. Venture Capital Funding) The conversion feature allows for flexibility with respect to the capital structure of the company depending on the options that are granted and can give both sides beneficial rights.

Anti-dilution/Preemptive Rights: Investors who purchase preferred shares will usually negotiate an anti-dilution provision associated with the conversion feature to protect them from significant dilution in the event of future stock issuances. This allows the investor to keep a certain percentage ownership of a company if more shares are issued later or shares convert as a result of conversion provisions. This is a very complicated area and requires the issuer to work closely with experienced their counsel, investment banker/broker dealer and company valuation expert.

2. **Is Preferred Stock a "Security" and Do I Have To Follow Securities Exchange Commission (SEC) Regulations If I Use It To Raise Capital?**

Yes & Yes. Preferred Stock is a security and if you sell it to Investors, you must comply with complex SEC and State regulations. Even if you give shares away to an employee, or issue stock to family member and do not receive cash, you must follow SEC law. You can find out more about this by clicking **here**.

3. **What are Some Advantages of Preferred Stock Over Convertible Debt from The Perspective of the Founder?**

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Investors are guided by three primary objectives when opting for preferred shares: (i) fixed income returns; (ii) a more stable value than common stock; and (iii) capital appreciation with downside protection through senior ranking in a liquidity event. In addition, some opt for Preferred Shares over Convertible debt for the following reasons:

a. Investors Understand Stock/Shares So You Do Not Have Trouble Selling It

While the Convertible Debt product is not that complex, we have found that it confuses many of our clients. Moreover, our clients feel that some unsophisticated Investors may not fully understand the conversion feature of convertible debt so will not buy it. In contrast, everyone knows what a stock is and this may be an easier sell to Investors (in particular friends and family). We also regularly represent investors and have come across many who first need a comprehensive lesson on convertible debt before they will consider it.

b. Interest Payments Do Not Have To Be Made & You Do Not Have Any Outstanding Debt

Convertible notes accrue interest from the date they are issued and even though the amount is not paid until some future date, this ultimately costs the company money as the amount (plus interest) has to be paid back. For equity, you are not required to include dividend payments and the product is clearly equity so does not have to be paid back.

c. Investor Has An Ownership Interest in the Company

Many investors are looking for control and as such opt for Preferred Stock with voting rights and a right to elect board of directors. With convertible debt, an Investor cannot elect board members or have any say in the direction of the company and this may not be that attractive for some Investors who desire more control

4. **Should A Founder Issue Convertible Debt or Equity?**

It depends. It is not possible to give an answer of which instrument (preferred stock v. convertible debt) is "best" and you should sit down with your lawyer to fully understand the different options to assess which one works best for you given your goals. In fact, many in industry have very different views on which product is the best product for start-up companies. Speak to a lawyer at Scott Legal Services, P.C. so that your options can be explained to you.

If you are considering issuing securities, contact Scott Legal Services, P.C. for a consultation. You can call us at 212-223-2964 or email us at iscott@legalservicesincorporated.com.