Drafting and Negotiating Convertible Preferred Stock Provisions: Protecting Interests of Businesses and Investors


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Drafting and Negotiating Convertible Preferred Stock Provisions

- Dividend and Liquidation Preferences
- Conversion Rights and Anti-Dilution Protection
- Redemption and Voting Rights
- Investor Rights Agreement
- Analysis of Sample Venture Capital Term Sheet

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This presentation should not be considered legal advice.
Drafting and Negotiating Convertible Preferred Stock Provisions
Dividend and Liquidation Preferences

Priority Dividend Rights (right to dividends in priority to junior series/classes of stock)

- **Cumulative and compounding:**
  - The holders of shares of the Series A Preferred Stock shall be entitled to annual dividends in an amount equal to x% of (i) the original issue price of the Series A Preferred Stock (as may be adjusted for stock dividends, splits and the like), plus (ii) all dividends then accrued [or accumulated], prior to and in preference to any dividend payment to the Common Stock.

- **Cumulative, but not compounding:**
  - The holders of shares of the Series A Preferred Stock shall be entitled to annual dividends in an amount equal to x% of the original issue price of the Series A Preferred Stock (as may be adjusted for stock dividends, splits and the like), prior to and in preference to any dividend payment to the Common Stock.

- **Non-cumulative:**
  - No dividends shall be declared on the Common Stock until each share of the Series A Preferred Stock has received a dividend equity to x% of its original issue price, when, as and if declared by the Board of Directors.
Drafting and Negotiating Convertible Preferred Stock Provisions
Dividend and Liquidation Preferences

Participating Dividend Rights (right to share in dividends to common stock)

- **Participating:**
  - After payment of the [priority dividend amount], any additional dividends shall be paid to the holders of shares of the Series A Preferred Stock and the Common Stock *pro rata* based on the number of shares of Common Stock then outstanding, assuming conversion in full of all of the issued and outstanding shares of the Series A Preferred Stock.
  - When, as and if declared by the Board of Directors, dividends shall be paid to the holders of shares of the Series A Preferred Stock and the Common Stock *pro rata* based on the number of shares of Common Stock then outstanding, assuming conversion in full of all of the issued and outstanding shares of the Series A Preferred Stock.
Priority Liquidation Preference (right to liquidation proceeds in priority to junior series/classes of stock)

- In the event of any Liquidation Event, the holders of shares of Series A Preferred Stock shall be entitled to receive, prior to and in preference to any distribution of the proceeds of such Liquidation Event (the “Proceeds”) to the holders of Common Stock by reason of their ownership thereof, Proceeds in an amount per share equal to the sum of the Original Issue Price for the Series A Preferred Stock, \textit{plus declared but unpaid dividends thereon}.

- In the event of any Liquidation Event, the holders of shares of Series A Preferred Stock shall be entitled to receive, prior to and in preference to any distribution of the proceeds of such Liquidation Event (the “Proceeds”) to the holders of Common Stock by reason of their ownership thereof, Proceeds in an amount per share equal to the sum of the Original Issue Price for the Series A Preferred Stock, \textit{plus accrued but unpaid dividends thereon, whether or not declared}.

- Can also provide for a multiple of the Original Issue Price.
Participating Liquidation Preferences (right to share in liquidation proceeds to common stock)

- **Non-Participating:**
  - Upon completion of the [Series A Preferred Stock’s priority preference] distribution, all remaining Proceeds available for distribution to stockholders shall be distributed to the holders of Common Stock pro rata based on the number of shares of Common Stock held by each.

- **Fully Participating:**
  - Upon completion of the [Series A Preferred Stock’s priority preference] distribution, all remaining Proceeds available for distribution to stockholders shall be distributed to the holders of shares of the Series A Preferred Stock and the Common Stock *pro rata* according to the number of shares of Common Stock (i) then held, with respect to holders of the Common Stock, and (ii) into which the issued and outstanding shares of the Series A Preferred Stock are then convertible.
Participating Liquidation Preferences (right to share in liquidation proceeds to common stock)

- **Capped Participating:**
  - Upon completion of the [Series A Preferred Stock’s priority preference] distribution, all remaining Proceeds available for distribution to stockholders shall be distributed to the holders of shares of the Common Stock and the Series A Preferred Stock (as if such holders of shares of the Series A Preferred Stock had converted their shares into shares of Common Stock in accordance with the provisions of Section [x] until the holders of shares of the Series A Preferred Stock have received, in addition to the amount of the [Series A Preferred Stock’s priority preference], *an amount equal to two times* the Original Issue Price for each share of Series A Preferred held by such holders. Thereafter, the remaining Proceeds available for distribution to stockholders shall be distributed ratably to the holders of shares of the Common Stock.
Conversion Rights

- **Voluntary Conversion:**
  - Each share of Series A Preferred Stock shall be convertible at the option of the holder thereof, without payment of additional consideration, into fully paid and nonassessable shares of Common Stock at any time after the date of issuance of such share. The number of share of Common Stock into which one share of Series A Preferred Stock is convertible is referred as the “Conversion Rate,” which shall be equal to the Original Issue Price of the Series A Preferred Stock divided by the Conversion Price. The Conversion Price shall initially be equal to the Original Issue Price of the Series A Preferred Stock and shall be subject to adjustment from time to time as provided for below.
Conversion Rights

- **Automatic Conversion:**
  - Each share of Series A Preferred Stock *automatically shall be convertible*, without payment of additional consideration, into fully paid and nonassessable shares of Common Stock at the then applicable Conversion Rate upon either of (i) the closing of a [Qualified IPO] or (ii) the affirmative vote of the holders of a majority of the then issued and outstanding shares of Series A Preferred Stock voting together as a separate class. The number of share of Common Stock into which one share of Series A Preferred Stock is convertible is referred as the “Conversion Rate,” which shall be equal to the Original Issue Price of the Series A Preferred Stock divided by the Conversion Price. The Conversion Price shall initially be equal to the Original Issue Price of the Series A Preferred Stock and shall be subject to adjustment from time to time as provided for below.

- **Qualified IPO considerations:**
  - Size of offering
  - Price per share
Anti-Dilution Protection for Non-Economic Dilution resulting from stock splits, stock dividends, reverse splits, etc.
- Adjustments are made to the Conversion Price to neutralize the effect of the triggering event.

Anti-Dilution Protection for Economic Dilution resulting from a down-round financing (a subsequent issuance of common stock equivalents at a pre-money valuation that is lower than the post-money valuation of the prior financings)
- **Full Ratchet Anti-Dilution Adjustment:**
  - If the corporation issues, on or after the Original Issuance Date, any “Additional Stock” for a consideration per share less than the Conversion Price for the Series A Preferred Stock in effect immediately prior to the issuance of such Additional Stock, the Conversion Price for the Series A Preferred Stock shall be adjusted to the amount of the per share consideration of the Additional Stock.
  - Additional Stock is generally defined as Common Stock Equivalents, subject to certain carve-outs.
Anti-Dilution Protection for *Economic Dilution resulting from a down-round financing* (a subsequent issuance of common stock equivalents at a pre-money valuation that is lower than the post-money valuation of the prior financings)

- **Broad-Based Weighted Average Formula Anti-Dilution Adjustment:**
  - If the corporation issues, on or after the Original Issuance Date, any “Additional Stock” for a consideration per share less than the Conversion Price for the Series A Preferred Stock in effect immediately prior to the issuance of such Additional Stock, the Conversion Price for the Series A Preferred Stock shall be adjusted as follows:

    \[ \frac{\text{# of outstanding CSE} + \text{No. of new CSE issuable at ECP}}{\text{No. of new CSE actually issued}} = \text{ECP times} \]

- **Narrow-Based Weighted Average Formula Anti-Dilution Adjustment:**
  - Same as Broad-Based, but with additional carveouts to the definition of Additional Stock
Drafting and Negotiating Convertible Preferred Stock Provisions
Redemption and Voting Rights

Redemption Rights

- **Redemption at the option of the holders**
  - Often subject to a time restriction (no redemption within the first five years)
  - Often subject to the vote of a majority of the holders

- **Redemption at the option of the company**
  - Often subject to a redemption premium

- **General Considerations**
  - Corporate statutory restrictions against prohibited distributions

Voting Rights

- **Right to vote with the common on an as-converted basis**
- **Right to board seats**
- **Protective provisions (separate class vote)**
Drafting and Negotiating Convertible Preferred Stock Provisions
Investor Rights Agreement

Additional Investor Rights

- Registration rights
- Preemptive/Participation rights
- Information and audit rights
- Voting agreements
- Transfer restrictions (tag-along/co-sale rights, rights of first refusal, etc.)
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TERM SHEET FOR THE OFFERING AND SALE OF
SERIES B PREFERRED STOCK OF XYZ, INC.

THIS TERM SHEET SUMMARIZES THE PRINCIPAL TERMS OF THE PROPOSED FINANCING OF XYZ,
INC., A DELAWARE CORPORATION (THE "COMPANY"). THIS TERM SHEET IS FOR DISCUSSION
PURPOSES ONLY; THERE IS NO OBLIGATION ON THE PART OF ANY NEGOTIATING PARTY UNTIL A
DEFINITIVE STOCK PURCHASE AGREEMENT IS SIGNED BY ALL PARTIES. THIS TERM SHEET DOES
NOT CONSTITUTE EITHER AN OFFER TO SELL OR AN OFFER TO PURCHASE SECURITIES.

Amount to be Raised: $__________.

Type of Security: Series B Preferred Stock ("Series B Preferred").

Number of Shares: _______ shares.

Purchase Price: $____ per share (the "Purchase Price").

Closing Date: The [initial] closing of the sale of the Series B
Preferred (the "[Initial] Closing") will be on or before
______, ______ [subject to a minimum sale of______
shares]. [Subsequent sales may occur within __
days of the Initial Closing until a maximum of __
shares have been sold.]

Rights, Preferences and
Restrictions of Preferred Stock:

Dividends: The holders of Series B Preferred will be
entitled to receive noncumulative dividends [in
preference to][on a parity with] the holders of Series
A Preferred Stock (the "Series A Preferred") and in
preference to the holders of Common Stock at an
annual rate of ____% of the Purchase Price per share
[with respect to the Series B Preferred and ____%
with respect to the Series A Preferred] from legally
available funds and when, as and if declared by the
Board of Directors.

Liquidation Preference: In the event of any
liquidation, dissolution or winding up of the Company,
the holders of Series B Preferred will be entitled to
receive [in preference to][on a parity with] the
holders of Series A Preferred and in preference to the
holders of Common Stock the amount of $____ per
share plus declared and unpaid dividends, if any, and
[thereafter] the holders of Series A Preferred will be
entitled to receive in preference to the holders of

Common Stock the amount of S____ per share], plus declared and unpaid dividends, if any [(the “Initial Payment”). After the Initial Payment has been made, the holders of Series A Preferred and Series B Preferred and the holders of Common Stock shall participate ratably until holders of Series A Preferred have received an aggregate of S____ per share and the holders of Series B Preferred have received an aggregate of S____ per share]. Thereafter, the remaining assets of the Company will be distributed ratably to the holders of Common Stock.

A Liquidation Transaction shall be treated as though it were a liquidation, for purposes of triggering an immediate obligation to pay an amount equal to the aggregate liquidation preference of the Preferred Stock. A “Liquidation Transaction” means an Acquisition of the Company, as defined immediately below, provided that if the holders of at least ____% of the Preferred Stock elect not to treat the transaction as a Liquidation Transaction, an Acquisition of the Company shall be deemed not to constitute a Liquidation Transaction.

An “Acquisition of the Company” means (i) a sale, conveyance or other disposition of all or substantially all of the property or business of the Company, (ii) a merger or consolidation with or into any other entity, unless the stockholders of the Company immediately before the transaction own 50% or more of the voting stock of the acquiring or surviving corporation following the transaction (taking into account, in the numerator, only stock of the Company held by such stockholders before the transaction and stock issued in respect of such prior-held Company stock), or (iii) any other transaction which results in (assuming an immediate and maximum exercise/conversion of all derivative securities issued in the transaction) the holders of the Company’s capital stock as of immediately before the transaction owning less than 50% of the voting power of the Company’s capital stock as of immediately after the transaction, provided, however, that an equity financing transaction in which the Company is the surviving corporation and does not (directly or through a subsidiary) receive any assets other than cash and rights to receive cash shall be deemed not to constitute an Acquisition of the Company. A series of related transactions shall be
deemed to constitute a single transaction, and where such transactions involve securities issuances, they shall be deemed “related” if under applicable securities laws they would be treated as integrated.

The liquidation preference of the Preferred Stock, if not specified in a merger agreement, will be paid 100% in the form of cash unless the Board of Directors elects to pay it in another form; if the Board does so elect, all stockholder of the same class must be treated equally.

**Redemption:** The Series B Preferred will not be redeemable, except to the extent the liquidation provisions specified above are deemed by any applicable law to constitute redemption.

**Voluntary Conversion:** Each holder of Series B Preferred will have the right, at the option of the holder at any time, to convert shares of Series B Preferred into shares of Common Stock at an initial conversion ratio of one-to-one.

**Automatic Conversion:** The Series B Preferred will be automatically converted into Common Stock, at the then applicable conversion rate, either (i) with the consent of the holders of a majority of the shares of Preferred Stock then outstanding, voting together as a class or, if earlier, (ii) immediately before the closing of a firm commitment underwritten initial public offering pursuant to a registration statement under the Securities Act of 1933, as amended, with aggregate gross proceeds of at least $____ million at a public offering price (adjusted for intervening common stock splits, reverse stock splits and stock dividends) of at least $_____ per share (a “Qualified IPO”).

**Antidilution Provisions:** The conversion price of the Series B Preferred will be subject to proportional adjustment for stock splits, stock dividends and the like (“Stock Split Changes”), [and to adjustments on a [broad-based weighted average] [narrow-based weighted average] [ratchet]] basis for issuances at a purchase price less than the then-effective conversion price, subject to the following carve-outs:

(i) common stock issued pursuant to stock splits and
common-stock-on-common-stock dividends,

(ii) [up to _____ shares of ] common stock issued or issuable [for compensatory purposes] to employees, officers, consultants or directors of the Company, or other persons performing services for the Company, directly or pursuant to a stock option plan or restricted stock plan or agreement approved by the Board of Directors[, including the Series A director representative and the Series B director representative then in office, if any (the “Preferred Directors”)];

(iii) capital stock, or options or warrants to purchase capital stock, issued to financial institutions with federal or state charters or to lessors in connection with commercial credit arrangements, equipment financings, commercial property lease transactions or similar transactions;

(iv) capital stock issued or issuable to an entity as a component of any business relationship with such entity for the purpose of (A) joint venture, technology licensing or development activities, (B) distribution, supply or manufacture of the Company’s products or services or (C) any other arrangements involving corporate partners that are primarily for purposes other than raising capital, the terms of which business relationship with such entity are approved by the Board of Directors [, including the Preferred Directors];

(v) capital stock, or warrants or options to purchase capital stock, issued in connection with bona fide acquisitions, mergers or similar transactions, the terms of which are approved by the Board of Directors [, including the Preferred Directors];

(vi) common stock or other underlying security actually issued upon conversion, exchange or exercise of any derivative security;

(vii) common stock issued or issuable in or under a Qualified IPO;

(viii) common stock issued or issuable as a result of the antidilution provisions of any derivative securities; and

(ix) common stock issued or issuable in or under a
transaction for which the holders of at least a majority of the then outstanding shares of Preferred Stock, voting together as a class, adopt a resolution that expressly states that such Common Stock is not to be considered Additional Shares.

**Voting Rights:** The holder of a share of Series B Preferred will be entitled to that number of votes on all matters presented to stockholders equal to the number of shares of Common Stock then issuable upon conversion of such share of Series B Preferred. Notwithstanding the foregoing, the Series B Preferred shall not be entitled to vote on any matter for which voting is expressly reserved, by law or the express provisions of the Company’s Certificate of Incorporation, solely for a class or classes of stock other than the Preferred Stock, or for one or more series of Preferred Stock other than the Series B Preferred.

**Protective Provisions:** So long as at least shares of Preferred Stock remain outstanding, the Company will not (by amendment, merger, consolidation or otherwise, and either directly or indirectly by a subsidiary), without the approval of a majority of the Preferred Stock, voting together as a class:

(i) effect (A) a liquidation, dissolution or winding up of the Company or (B) an Acquisition of the Company,

(ii) alter or change the rights, preferences or privileges of the Preferred Stock so as to materially and adversely affect such shares;

(iii) increase or decrease the number of authorized shares of the Preferred Stock, the Series A Preferred or the Series B Preferred;

(iv) authorize the issuance of securities having a preference over or on a parity with the Series A Preferred or Series B Preferred as to dividends or liquidation or that involves the issuance of any Company security, other than securities that fall within an express carveout to the antidilution
provisions and that are not restricted by another protective provision]

(v) redeem, repurchase or otherwise acquire shares of Preferred Stock or Common Stock other than in accordance with [the redemption provisions of the Preferred Stock or] the repurchase of shares from employees, officers, directors, consultants or other persons providing services to the Company at no greater than cost pursuant to the original terms of such agreements, or such modified terms as have been agreed to by the Board of Directors [including the Series A director representative and the Series B director representative then in office, if any].

Registration Rights:

Registrable Securities: All shares of Common Stock issuable upon conversion of the Preferred Stock shall be deemed “Registrable Securities.”

Demand Registration: Beginning _____, or six months after a Qualified IPO, whichever is earlier, demand registrations of at least $_______ each, upon initiation by holders of ___% of the outstanding Registrable Securities.

Piggyback Registration Rights: Unlimited piggyback registration rights, subject to pro rata cutback to a minimum of ___% of the offering (complete cutbacks on the IPO) at the underwriter’s discretion.

Registration on Form S-3: The holders of at least ___% of the Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, shares of Registrable Securities for an aggregate offering price of at least [$500,000]. The Company will not be obligated to effect more than two S-3 registration statement in any twelve month period. [There shall be a limit of a total of ___ such S-3 registrations.]

Registration Expenses: Registration expenses (exclusive of underwriting discounts and commissions, stock transfer taxes and fees of counsel to the selling stockholders) will be borne by the Company for all demand, piggyback and S-3 registrations. The Company will also pay the reasonable fees and expenses of one special counsel to the selling
stockholders[, not to exceed $______].

**Assignment of Registration Rights:** The registration rights may be transferred to a transferee who acquires at least ______ shares of the original purchaser’s Registrable Securities (or all of the transferring holder’s shares, if less), provided that the Company is given prompt notice of the transfer and the transferee agrees to be bound by the terms and conditions of the Investors’ Rights Agreement. Transfer of registration rights to a partner or affiliate of the transferee will be without restrictions as to minimum shareholdings.

**Lock-up Agreement:** In connection with a Qualified IPO, each holder of registration rights will be required not to sell or otherwise dispose of any securities of the Company (except for those securities being registered) for a period of 180 days following the effective date of the registration statement for such offering if so requested by the underwriters of such offering subject to such extensions of time as may be required by the underwriters under NASD Rule 2711 or a successor rule. [In addition, each holder of registration rights will agree to be bound by similar restrictions, and be bound by similar agreements, with respect to one additional registration statement filed within 12 months after the IPO, provided that the duration of the lock-up with respect to such additional registration shall not exceed 90 days.]

**Termination of Registration Rights:** The registration obligations of the Company will terminate on the earliest of (i) ___ years after a Qualified IPO, (ii) with respect to any holder of registration rights, at such time as all Registrable Securities of such holder may be sold within a three month period pursuant to Rule 144 or (iii) upon an Acquisition of the Company.

**Information Rights:**

So long as a holder of Series B Preferred continues to hold [at least _____] shares of Series B Preferred or Common Stock issued upon conversion of Series B Preferred, the Company will deliver to such holder annual, quarterly and monthly financial statements as well as an annual budget. The obligation of the Company to furnish such information will terminate at the earlier of (i) such time as the Company becomes subject to the reporting provisions of the Securities
Right of First Offer:

Each holder of at least ___ shares of the Series B Preferred will have the right in the event the Company proposes to offer equity securities to any person other than:

(i) common stock issued pursuant to stock splits and common-stock-on-common-stock dividends,

(ii) [up to _____ shares of] common stock issued or issuable [for compensatory purposes] to employees, officers, consultants or directors of the Company, or other persons performing services for the Company, directly or pursuant to a stock option plan or restricted stock plan or agreement approved by the Board of Directors[, including the Preferred Directors];

(iii) capital stock, or options or warrants to purchase capital stock, issued to financial institutions with federal or state charters or to lessors in connection with commercial credit arrangements, equipment financings, commercial property lease transactions or similar transactions;

(iv) capital stock issued or issuable to an entity as a component of any business relationship with such entity for the purpose of (A) joint venture, technology licensing or development activities, (B) distribution, supply or manufacture of the Company’s products or services or (C) any other arrangements involving corporate partners that are primarily for purposes other than raising capital, the terms of which business relationship with such entity are approved by the Board of Directors [, including the Preferred Directors];

(v) capital stock, or warrants or options to purchase capital stock, issued in connection with bona fide acquisitions, mergers or similar transactions, the terms of which are approved by the Board of Directors [, including the Preferred Directors];

(vi) common stock or other underlying security actually issued upon conversion, exchange or exercise of any derivative security;

(vii) common stock issued or issuable in or under a
Qualified IPO;

(viii) common stock issued or issuable as a result of the antidilution provisions of any derivative securities;

(ix) securities issued with the affirmative vote of at least [a majority of] the then outstanding shares of Preferred Stock, voting together as a class; or

(x) securities that, with the approval of every then-sitting member of the Board of Directors, are not offered to any existing stockholder of the Company.

Such right of first offer shall consist of a right to purchase that portion of such equity securities equal to (i) the number of shares of Common Stock issued or issuable upon conversion of the Series B Preferred held by such holder of Series B Preferred divided by (ii) all of the Company’s Common Stock then outstanding or issuable upon exercise of options or warrants or conversion of Preferred Stock.

Such right of first offer will terminate upon a Qualified IPO or upon an Acquisition of the Company. The right of first offer shall not be applicable with respect to any covered investor and any subsequent securities issuance, if (i) at the time of such subsequent securities issuance, such investor is not an accredited investor, and (ii) such subsequent securities issuance is otherwise being offered only to accredited investors.

Co-Sale Right [and Right of First Refusal]:

Holders of Preferred Stock shall have the right to participate on a pro-rata basis in transfers of stock for value by _________ and _________ (the “Founders”) (with customary exceptions for transfers in connection with estate planning and similar matters and an exception for up to __% of each Founder’s common stock). This right will terminate immediately before a Qualified IPO or an Acquisition of the Company.

The existing right of first refusal and vesting provisions with respect to the Founders’ stock will remain in effect. [The right of first refusal will be assigned to the holders of the Preferred Stock on a pro-rata basis in the event it is not exercised by the Company.]
[Board of Directors:
The preferred stock of Series A and Series B shall be entitled to elect member(s) of the Company’s Board of Directors, and the remaining members will be elected by the Preferred Stock and Common Stock voting together as a class. Upon closing of the Financing, the Board of Directors of the Company shall consist of directors, with directors designated as the Series B Preferred Stock directors.]

[Exclusivity:
In consideration of investing substantial time, effort and expense in connection with the evaluation and execution of the transactions contemplated by this term sheet, the Company agrees that it will immediately cease any and all discussions or interactions with third parties concerning alternative financing transactions and, for a period of time expiring on the earlier of or the date that shall have notified the Company in writing that it does not intend to proceed with the transactions contemplated hereby, (a) the Company and will work in good faith toward the consummation of the transactions contemplated by this term sheet and (b) the Company will not negotiate with, provide information to, or otherwise interact with any third party concerning any alternative transaction.]

Purchase Agreement:
The sale of the Series B Preferred will be made pursuant to a stock purchase agreement reasonably acceptable to the Company and the Investors, which agreement will contain, among other things, appropriate representations and warranties of the Company and the Investors, covenants of the Company reflecting the provisions set forth in this term sheet and appropriate conditions to closing which will include, among other things, qualification or exemption of the shares to be sold under applicable Blue Sky laws, and the filing of Amended and Restated Certificate of Incorporation.
SELECTED TAX ISSUES IN DRAFTING AND NEGOTIATING CONVERTIBLE PREFERRED STOCK PROVISIONS

Strafford Live Webinar, May 8, 2014
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Avoiding “phantom” dividends (including related withholding tax issues)

Ensuring capital gains treatment on exit
**General Rule of Section 305: Stock dividends not taxable**
- Example: Corporation X has 4 shareholders, each of which holds 100 shares of common stock. If X distributes 100 additional shares to each shareholder, this is not taxable under Section 305

**Exceptions:**
- Elective receipt of cash or stock
- Disproportionate distribution (property to some, increase in proportionate ownership to others)
- Distribution of common and preferred (to common stockholders)
- Distributions on preferred stock
- Distributions of convertible preferred stock

**Application to convertible preferred stock**
- Actual stock dividends: PIK dividends
- Deemed stock dividends: Section 305(c)
- Note: Because of U.S. withholding tax rules, this can present issue for issuer as well as investor
No tax under §305 if issuer does not have accumulated or current earnings and profits

§305 largely, but not entirely, avoided if stock is treated as common, and not as preferred, for tax purposes

- Preferred stock “does not participate in corporate growth to any significant extent” (Treas. Reg. § 1.305-5(a))
- Key feature indicating treatment as common stock is participation in upside on liquidation
  - Typical formulations: Full participation vs. “greater of” formulation
- Participation in dividends probably not necessary, but desirable and generally acceptable to company
- Conversion feature is not taken into account
Even if structured as common stock for tax, convertible preferred still presents potential for phantom dividends under “disproportionate distribution” rule (IRC § 304(b)(2))

Example: Corporation X has two classes of preferred stock outstanding, Series A preferred, which is treated as preferred for tax purposes, and Series B convertible preferred which is treated as common for tax. If X pays a cash dividend on its Series A, and also distributes additional Series B shares to each Series B shareholder, the stock distribution is taxable under Section 305.

Transactions to note: interest payments on convertible debt; redemptions treated as dividends under IRC § 302

No plan necessary if two distributions are within 36 months
Section 305(c) creates deemed stock dividends that then can be subject to tax under one of the Section 305(b) exceptions.

Categories
- Change in redemption price
- Change in conversion ratio (except pursuant to “reasonable” anti-dilution provision)
- Redemption premium
- Any transaction (e.g., recapitalization) having a similar effect

Application to convertible preferred terms
- Accruing dividends
- _x liquidation preferences
Example involving changes in conversion ratio:

X corporation has two classes of stock outstanding, Class A and B. The Class B shares are convertible into Class A shares at a 1-to-1 ratio the first year. Thereafter, the conversion ratio gives the Class B shareholders an additional .05 shares of Class A stock each year. Accordingly, during the second year, the conversion ratio would be 1.05 shares of Class A stock for each share of Class B stock; during the third year, the ratio will be 1.10 shares of Class A stock for each share of Class B stock, and so on. Cash dividends are paid by the corporation annually on the Class A stock. At the beginning of the second year, when the conversion ratio is increased to 1.05 shares of Class A stock for each share of Class B stock, a distribution of .05 shares of Class A stock is deemed made with respect to each share of Class B stock, since the proportionate interests of the Class B shareholders in the assets or earnings and profits of the corporation have increased disproportionately to those of the Class A shareholders. (Treas. Reg. § 1.305-3(e), Ex. (6))
Example involving redemptions (must be part of a plan of periodic redemptions):

X corporation (X) has 10 shareholders, each of whom own 100 shares of X stock. Each year, each shareholder has the option of causing the corporation to redeem up to 5% of his stock. Assume nine out of the 10 shareholders elect to have five of their shares redeemed for cash, but that shareholder A does not. A's proportionate interest in the earnings and profits and assets of X is increased, and he is deemed to receive a taxable distribution of 5.25 shares. (Treas. Reg. § 1.305-3(e), Ex. (8))
Example involving redemption premium:

On January 1, 2014, corporation (X) issues 100 shares of preferred stock to C at $100/share. The stock is mandatorily redeemable on January 1, 2017 for $150/share. The $50 redemption premium is accrued by C over the three year period ending on January 1, 2017. (See Treas. Reg. § 1.305-3(e), Ex. (8))
Typical exit possibilities:

- Conversion
- Redemption

Tax treatment upon conversion

- In general, should be a tax free recapitalization (IRC § 368(a)(1)(E))
- Possible application of 305(c) if (1) exchanged stock was treated as preferred for tax, (2) had dividends in arrears and (3) FMV or liquidation pref of new stock exceeds issue price of exchanged stock
Example involving recapitalization:

A corporation has both common and preferred stock outstanding, the latter having an issue price of $100 per share. The corporation is four years in arrears on dividends to the preferred shareholders. In a recapitalization, under §368(a)(1)(E), the preferred shareholders exchange each share of their existing preferred stock (including the right to dividend arrearages) for 1.20 shares of new Class A preferred stock, which has a liquidation preference of and is traded in the market at $100 per share immediately following the recapitalization. Since the fair market value of 1.20 shares of new Class A stock is $120, which exceeds the issue price of the old preferred stock, the preferred shareholders have increased their proportionate interests in the assets and earnings and profits of the corporation. Thus, the preferred shareholders are deemed to have received a taxable distribution of $20 on each share of the old preferred stock. (Treas. Reg. § 1.305-5(d), Ex. (1))
Tax treatment upon redemption

- In general, should be treated as sale or exchange (and therefore eligible for capital gains) if complete termination of shareholder’s interest
- Possible dividend treatment if accrued dividends are declared or set aside prior to redemption
SUMMARY CONSIDERATIONS

- Ensure that convertible preferred stock is structured to qualify as common stock for tax purposes where possible.

- Watch for deemed distributions under Section 305(c) and consider impact of interest payments on convertible debt.

- On exit, avoid creating taxable dividends.
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Justin has previously spoken on tax matters at the USC Tax Institute, Southwestern Law School and Beverly Hills Bar Association, and is an Adjunct Professor in the Tax LL.M. program at Loyola Law School.

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