Choices for Structuring Preferred Stock Offerings – Bruce E. Methven

As mentioned last time, there are many ways to structure securities to be sold in an offering. How they are structured requires balancing what is attractive to investors with what the company can live with.

In terms of equity offerings, for corporations equity takes the form of stock (either common or preferred) and for LLC's and limited partnerships it takes the form of units or percentages of ownership. LLC's and limited partnerships can also have different classes of ownership that are analogous to common and preferred stock. Although here the references will be to preferred stock, keep in mind that the concepts apply to LLC's and limited partnerships as well.

Preferred stock can be arranged in many forms. Sometimes complicated preferred stock definitions can run for pages, but the key concepts are fairly straightforward.

Liquidation Preferences and Dividends

Almost always preferred stock has a liquidation preference, meaning that if the company is liquidated or sold the preferred shares receive payment as designated (at the very least the return of the money paid and sometimes unpaid dividends) before the common shares receive anything. A liquidation preference is a method of reducing the risk to investors that they may not get their money back.

In addition, preferred stock usually has specified dividends, but that is different from promissory note payments in that dividends are paid only if the company meets legal requirements (such as being able to pay expenses) and often only if a specified reserve amount is retained. State law may impose requirements regarding preferred stock, such as giving the preferred shareholders representation on the board of directors if a total of eight quarterly dividends are outstanding.

Conversion and Buyback Rights

Frequently preferred stock is structured so that it automatically converts to common stock if the company goes public. Sometimes preferred stock can be converted at any time – or after a specified time or occurrence – at the option of the holder.

The company may also have the right to convert the stock after a specified total of dividends are paid or a specified time has passed. In addition, preferred stock can be structured something like a bridge loan, so that it is convertible if the company raises a target amount of money in the future (so that presumably the investment in the company is less risky). This type of "convertible equity" has become something of a hot topic lately.

Preferred stock can also be arranged so that in certain circumstances the company has buyback rights, sometimes with a premium added to the original price and any unpaid dividends. This can be useful if the company is considering future financing and is concerned that the company may be less attractive if it has outstanding preferred stock. A company may also want buyout rights so that it does not have to keep making what may be high dividend payments to preferred stockholders forever. In addition, companies frequently find it useful to have a buyout option so that if there is a troublesome investor the company can resolve that situation by buying out that investor.

Voting and Anti-Dilution

Usually preferred stock has no voting rights or limited voting rights. That is done so that the holders of the common stock can maintain control over the board of directors and therefore the officers of the company (which are chosen by the board). The same issue exists regarding managers of limited liability companies or limited partnerships: without some voting restrictions (or at least super-majority voting requirements) the management, which is often the founders, could be replaced.

Sometimes preferred stock is defined so that the percentage of the company interests it represents is not reduced if additional investors are added later. This “anti-dilution” feature can be attractive to investors, but it can also leave the common shares in the position of being diluted even more than they otherwise would be if additional investors are needed. Again LLC (or limited partnership) interests can be structured in the same ways as preferred shares.

In structuring the securities it offers, the company has to weigh what features will be attractive to the investors against the limitations those features may impose on the rights of the other owners.

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