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Chart: Preferred Stock in Private Equity Transactions—Key Characteristics

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This chart is designed to provide an overview of the main terms and characteristics of preferred stock equity financings. It assumes the Company offering securities is organized as a Delaware corporation. The chart is divided into three sections: Term Sheet Terms: General Overview; Documenting Preferred Stock Sales; and Typical Terms of Preferred Stock Transactions. It is meant to serve as a general guideline for the most common terms of a preferred stock financing.

Most practitioners use the model forms, or a derivative of the forms, provided by the National Venture Capital Association (NVCA), although some law firms have their own forms based on the NVCA documents. This chart assumes that the documentation of a preferred stock equity financing will follow the basic forms most widely used in practice.

For purposes of this chart, we are assuming the Company is a Delaware corporation. Venture capital investors will generally require investment in a corporation, rather than a limited liability company, to avoid pass-through taxation. Delaware corporations are the most common entities used.

Of course, every transaction is unique and subject to different structures, negotiations and power dynamics between a Company and its investors. Accordingly, this chart cannot be considered exhaustive, but rather is a starting point for practitioners to become familiar with the most common terms of preferred stock financings.

Preferred Stock in Private Equity Transactions—Key Characteristics

Term; Provision; Documentation	**Explanation and Considerations**
Term Sheet Terms: General Overview	
Type of Security Purchased	Preferred stock investors are purchasing a series of preferred stock in the Company. After a seed round, the purchaser may be purchasing Series A, Series B, Series C, etc., preferred stock, depending on which round of financing the Company is consummating.
Seniority	A new series of preferred stock will usually have seniority over a previously authorized series of preferred stock and common stock in terms of liquidation preference and dividends.
Aggregate Proceeds	Typically, the Stock Purchase Agreement will stipulate that the Company may sell up to a certain amount of securities (expressed as a dollar figure) in the round of financing.

Price Per Share	The price per share at which the stock will be sold determines the number of shares to be sold (Proceeds ÷ Price Per Share = Number of Shares Sold). It is important to authorize a sufficient number of shares in the Company's Certificate of Incorporation.
Capitalization	In addition to authorizing sufficient numbers of shares of preferred stock and common stock (for issuance upon conversion of preferred stock, conversion of warrants and option exercises), as a condition to closing Investors will require an updated capitalization table. Ownership percentages should be set forth on a series-by-series and fully-diluted basis.
Use of Proceeds	Typically, proceeds will be used for "working capital and general corporate purposes." However, more specific uses of the proceeds may be negotiated by the parties, especially if the investors want to ensure their capital is used for specific purposes. Another way to ensure that investors' capital is used for specific purposes is to incentivize the Company to take certain actions or achieve certain results. "Milestone" closings are subsequent investments made by investors upon the occurrence of certain events. These can be technical achievements (for example, in the healthcare technology space, obtaining FDA approval or certain results in a study or clinical trial) or more general achievements (for example, achieving certain revenues over a period of time). Upon the achievement of a milestone, investors are obligating themselves to invest more money into the Company by purchasing additional shares of preferred stock. These investments are effected at a milestone closing.
Documenting Preferred Stock Sales	
Certificate of Incorporation	The Certificate of Incorporation contains the general overview of the characteristics of each series of stock, including common stock and any series of preferred stock. It includes information relating to authorization of the capital stock, dividend rights, liquidation preferences, redemption preferences, conversion of preferred stock into common stock, anti-dilution protection, basic voting rights, protective provisions and other fundamental corporate information.

Stock Purchase Agreement	The Stock Purchase Agreement, or SPA, is the basic purchase and sale document under which investors purchase preferred stock from the Company. It contains information regarding closing, representations and warranties of the Company and the investors, and conditions to closing (including any milestone closings). Other than basic fundamental representations, the representations and warranties are often specific to the industry in which the Company operates. For example, investors will often require healthcare companies to make representations relating to patient privacy and FDA approvals, while a manufacturing company may be forced to make environmental safety representations.
Investors' Rights Agreement	The Investors' Rights Agreement, or IRA, contains certain rights of the investors upon the purchase of preferred stock. These include, for instance, rights to force the Company to register securities with the Securities and Exchange Commission, indemnification rights, rights to receive information about the Company and its business, and rights to observe the Board of Directors. In addition, certain select "major investors" are usually entitled to a right of first offer if the Company proposes to offer or sell any new securities. If a major investor does not elect to participate, the remaining major investors typically have the opportunity to acquire or purchase these unsubscribed shares. Also, major investors may be given "put" rights enabling them to require the Company to repurchase their preferred stock at or after a particular time or under specified circumstances, at an agreed price per share or based on a formula for determining the relevant price; this enables the investor to exit the investment in the absence of an IPO or sale of the Company. Lastly, on occasion (although this is rare), investors may be subject to a "call" right, enabling the Company to require the investors to sell their preferred stock back to the Company at or after an agreed time or event, and based on agreed pricing. Investors such as venture capital funds, which have third party limited partners such as pension funds or university endowments, are usually especially careful to secure these types of rights as they are fiduciaries for their limited partners and, accordingly, need to be in a position to diligently monitor and protect their investment.

Voting Agreement	The Voting Agreement is the instrument by which investors are entitled to designate members of the Board of Directors of the Company. The investors will generally negotiate for the right to name a director (and other shareholders agree to vote their shares in favor of such individual's election to the Board) and the right to remove such directors. In addition, the Voting Agreement generally provides for the right of holders of a specified percentage of preferred stock to drag the other stockholders along in a sale of the Company.
Right of First Refusal/Co-Sale Agreement	The Right of First Refusal and Co-Sale Agreement, or ROFR/ Co-Sale Agreement, gives the Company first, and the investors second, a priority right to purchase the stock of a holder who wishes to sell their stock to a third party. In addition, the ROFR/ Co-Sale Agreement usually contains a right of the investors to join in the sale of the selling holder's stock (a "co-sale right") in the event they do not exercise their right of first refusal. It may also provide a "pre-emptive" right, giving investors the right to purchase their pro rata shares of stock to be issued by the Company in subsequent rounds of financing.
Typical Terms of Preferred Stock Transactions	
Dividends	Preferred stock may or may not provide for dividends. Any dividends payable on preferred stock typically are in preference to the payment of dividends on any other series of stock (including common stock), in descending order of seniority. Dividends may be compounding or non-compounding and, in addition to the payment of the preferred dividend, the preferred stock may also be able to participate with the common stock (on an "as-converted" basis) in the payment of dividends on common stock (such preferred stock is referred to as "participating preferred" stock). Dividends can be tied to a specific amount per share (e.g., $0.15 per share annually) or be calculated based on a percentage of the purchase price per share of preferred stock or based on a floating rate depending on a benchmark index. Dividends are usually payable in cash, but can also be payable in common stock, additional preferred stock, other property or payable-in-kind.

Liquidation Preference	Preferred stock is entitled to preferential treatment in the event of a liquidation. A liquidation includes the Company's liquidation, winding up or dissolution, but may also be "deemed" to include a merger, consolidation, sale, or lease or conveyance of all or a substantial portion of the Company's assets. By including such change of control events in the definition of liquidation, the holders of preferred stock can ensure preferred treatment in the event of a major transaction or corporate occurrence. The liquidation preference ensures that holders of preferred stock are paid their purchase price (or a multiple of their purchase price), plus all accrued but unpaid dividends, prior and in preference to the holders of any other series of stock (including common stock) in order of seniority. If the preferred stock is "participating preferred," it will participate (on an as-converted basis) in liquidation-related distributions with the common stockholders in the payment of amounts which may remain after payment of the liquidation preference to all of the series of preferred stockholders is completed.
Conversion to Common Stock	Preferred stock may or may not be convertible into common stock. If it is convertible, key issues are the conversion price, under what circumstances there may be an adjustment of the conversion price, whether conversion is optional or mandatory (and upon what situations) and anti-dilution protection. Anti-dilution protection means that if there is a dilutive event (e.g. a stock split or combination, or the issuance of stock at a lower price than what the investors paid for their stock), the conversion ratio can be adjusted to put the investors back into the position they enjoyed before the dilutive event. How much the conversion price is adjusted is a factor of whether the preferred stock is subject to full-ratchet or weighted-average anti-dilution protection. In full-ratchet, if the protected investor's conversion price is $1.00 and the Company's issues one additional share to a new investor for $0.05, then the protected investor's conversion price for all of its preferred shares adjusts to $0.05 (and the protected investor would get 20x the number of shares upon conversion as was originally contemplated). In weighted-average, the protected investor's conversion price would be adjusted based on the total number of shares purchased by the protected investor and the new investor, and the total amount paid for such shares. Most companies provide for weighted-average protection since full-ratchet anti-dilution is punitive to the Company (and the founders and shareholders in rounds prior to the protected investors), and may make it more difficult to raise additional funds in the future. For privately-held companies, preferred stock is often automatically convertible in connection with an initial public offering, within certain parameters (e.g. if the IPO will raise more than a stated amount of proceeds, such as $100 million, and value the Company at a certain multiple, such as 3x or more the valuation reflected in the protected investor's preferred stock purchase price, then conversion is automatic).

Rights to Redemption	Preferred stock may or may not be redeemable. If preferred stock is redeemable, there are often time and milestone restraints as to when the preferred stock becomes redeemable (e.g. if within three years after the protected investor's investment, the Company has not done an IPO or has not achieved specified financial results or operating objectives such as the commercialization of a drug or the launch of a software product). In addition, redemption may be optional (i.e., in the protected investor's discretion) or mandatory and may or may not come with a premium. The redemption price is a point of negotiation, but most often there is a fixed redemption price, subject to adjustment for additional issuances of stock. Usually, redemption includes the payment of accrued but unpaid dividends. Generally, the amount paid in redemption is designed to provide the protected investor with a minimum internal rate of return on its investment, where the Company has only been modestly successful. A practical consideration is whether the Company has enough money to redeem all shares of preferred stock with redemption rights. If there is a mandatory redemption event but insufficient funds for the Company to effect a full redemption of all shares subject to the redemption right, the Company must redeem those shares it is unable to redeem as soon as the Company has the funds to do so. Often, the Company will be foreclosed from completing a transaction that would trigger a mandatory redemption (a change of control transaction or voluntary liquidation, for example) unless it has sufficient funds to redeem all preferred shares.
Unique Voting Rights	Holders of preferred stock usually enjoy certain special voting rights. On matters requiring a basic stockholder vote, holders of preferred stock are treated in the same way as holders of common stock (i.e., they vote with the common stockholders on an as-converted basis). However, holders of preferred stock usually have specific "protective provisions," which are highly negotiated terms of any preferred stock financing. In order for a Company to take the actions identified under the "protective provisions," the Company must first obtain the affirmative vote of the preferred stockholders. Usually, this is expressed as the vote of the preferred stockholders holding a percentage of the outstanding preferred stock (e.g. "the holders of 60% of the preferred stock"). Holders of different series of preferred stock (Series B v. Series A, for example), may have different protective provisions. Commonplace protective provisions that require a separate vote of the holders of preferred stock for the Company to be allowed to take certain actions include: • Amending the Company's Certificate of Incorporation or bylaws; • Authorizing or creating any stock or series ranking senior or equal to the preferred stock in terms of distribution of assets upon a liquidation or dividend payments; • Merging or consolidating the Company;

	• Increasing or decreasing the number of directors on the Board of Directors; • Purchasing or holding securities in any other Company that is not a wholly-owned subsidiary or selling all or a substantial portion of the assets of a subsidiary; • Accruing debt in excess of a stated amount; • Changing the business of the Company in a material way; • Borrowing money (in excess of agreed amounts); • Approving annual budgets and operating plans; • Purchasing or redeeming shares of stock; and • Amending the protective provisions. The foregoing list of protective provisions is not exhaustive and depending on the business, industry and identity of the investors, the protective provisions may be much more robust.
Board Observer Rights	Preferred stock investors often acquire the right to designate a member of the Board of Directors, but an alternative is the right to appoint a Board Observer. Board Observers are non-voting representatives that observe Board of Directors meetings, subject to confidentiality restrictions. An investor in a weaker position than that required to obtain the right to designate a member of the Board of Directors will often negotiate for the right to designate a Board Observer (these are usually not the lead investors, but smaller investors participating in a preferred equity round).
Information Rights	Preferred stockholders that hold a certain threshold percentage of preferred stock are granted information rights, including the right to review the Company's audited and unaudited financial statements and inspect the Company's books of account and records. Information rights are subject to confidentiality restrictions. The purpose of information rights is to allow the major investors to keep track of the Company's financial performance and corporate upkeep. This ensures that the Company is not squandering the investors' capital investment.

Registration Rights	Preferred stock is usually restricted stock (i.e. the holder cannot freely sell the stock to third parties). This is often the case in private companies to ensure compliance with securities laws. However, in order to enable the holder to liquidate its investment at some point, the holder can exercise its registration rights and require the Company to register shares of common stock (issuable upon conversion of the preferred stock) with the Securities and Exchange Commission, and to apply to list such shares for public trading on a recognized stock exchange, upon certain conditions. "Demand" registration rights allow holders of preferred stock (usually the holders of a specified percentage of a particular series of preferred stock) to require the Company to register the holder's shares for sale to the public, usually after a certain period of time following the holder's acquisition of preferred shares or following the Company's initial public offering. Usually, the right of preferred holders to demand registration is limited to once or twice per calendar year. "Piggyback" registration rights allow holders of preferred stock to request that some of the holders' shares be included in the Company's registration of shares to be newly-issued by the Company and sold to raise money for the Company's use. Piggyback registrations occur on the same terms and conditions as the proposed registration. A commonly negotiated term is the lock-up or "market standoff" provision. This requires stockholders subject to the lock-up to hold their shares for a specified period after an IPO (typically 180 days, subject to extended periods if an underwriter deems it necessary) and not sell them into the public market. A lockup is often required by underwriters to ensure that they control the influx of the Company's shares into the public market and, consequently, the market price of the shares. Registration rights usually expire a certain period of time after an IPO, when the holder can freely sell its shares (after conversion into common stock) on the open market under the relevant US securities laws without having to go through the registration of such shares with the Securities and Exchange Commission.

Preemptive Rights	Preferred stock investors usually require preemptive rights, which are first refusal rights to preserve the holders' proportional ownership interest in the event the Company issues equity securities in a subsequent financing round. Typically, preferred stockholders will be afforded the right to purchase securities in a new equity round to maintain their pro rata ownership interest. The purchase of new securities is typically on the same terms and conditions as those offered to participants in the new financing round.
Rights of First Refusal	The Company sometimes enjoys a right of first refusal in the event a holder (usually limited to certain key holders, such as a founder or key executive) attempts to sell its stock to a third party. The Company has the right to buy the shares proposed to be sold. A second refusal right is usually granted in favor of the preferred investors who own a specified amount of preferred shares. Generally, the purpose of first refusal rights is to allow the current owners and investors control over the identity of, and ownership percentage of, new investors.
Rights of Co-Sale	Preferred investors are also granted rights of co-sale, or the right to participate in a sale of another investor's preferred stock so that the preferred investors are also bought out on the same terms. A Right of First Refusal and Co-Sale Agreement will require that any purchase agreement provide a put right in favor of the preferred investors against the other selling investor if such selling investor fails to procure that the protected preferred investors have their "co-sale" shares included in the relevant sale. Failure to comply with a right of co-sale means that any transfer is void and the holder of the co-sale right can apply for equitable relief.
D&O Insurance	An oft-negotiated term is the provision of directors and officers insurance. An investor appointing a member of the Board of Directors will want to ensure that the director is protected by an insurance policy maintained by the Company. Maintenance of an insurance policy may be included as a condition precedent to closing under the Stock Purchase Agreement. In addition, an investor will want the Company to act as the "indemnitor of first resort" in case its appointed director requires financial indemnification. Being "indemnitor of first resort" means that the Company will indemnify the director in the case of liability before the venture capital investor (who appointed the director) is required to indemnify the director (usually, directors are employees of the venture capital investor and enjoy certain rights to indemnification under their employment agreements). A venture capital investor that appoints a director will require that any liability incurred by that director while acting in his capacity as a director will be covered by the Company and not the investor (subject to usual carve outs if the director acts in bad faith, etc.).

Legal Counsel and Fees	A venture capital investor will often ask the Company to pay the reasonable legal fees of one counsel for the investor group. This is more a matter of semantics since the Company will be paying the legal fees with cash (a fungible asset) that it just received from the venture capital investor. Often, the parties negotiate a reasonable cap to any fees paid by the Company.