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Protecting Minority Securityholder Rights

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Methods of Protecting Minority Securityholders

Fiduciary principles and other securityholder rights imposed by applicable state corporate, partnership and trust laws generally do not provide adequate protection for holders of minority (non-control) interests in a corporation or other business entity. In order to protect their interests, minority securityholders will negotiate certain safeguards with the issuer entity and the issuer's control securityholders. The issuer and its controlling securityholders, on the other hand, will try to limit these rights so that the minority does not have an effective veto over the issuer's ability to raise capital and make other business decisions.

The rights of control securityholders and minority securityholders typically are contained in an agreement, such as a stockholders agreement, limited partnership agreement or limited liability company operating agreement. In addition, specific securityholder concerns may be addressed in other specialized agreements such as a registration rights agreement or a co-sale agreement. These rights may also be governed by the terms of the securities purchased, especially in the case of securities such as convertible preferred stock, convertible debt instruments or security purchase warrants, which can be converted into or exercised to acquire common stock or other securities of the issuer.

Minority securityholders typically negotiate provisions that:

- protect their rights to sell or otherwise exit their investment, such as tag-along rights, registration rights, buy-sells or puts;
- protect against dilution, such as anti-dilution adjustments, preemptive rights to purchase newly issued securities from the issuer, rights of first refusal to purchase securities from other securityholders, and, for preferred stock, preferences on liquidations and distributions; and
- provide for participation in governance, such as board seats, access to issuer information, input on executive compensation and transactions with management and affiliates, and participation in major corporate transactions.

Although control securityholders naturally need less protection, they typically negotiate provisions that:

- limit transferability of securities;
- require minority securityholders to consent to and participate in sales of the issuer (so-called drag-along rights);
- impose confidentiality obligations regarding issuer information;

- afford to the control securityholders the same preemptive rights and rights of first refusal afforded to the minority securityholders; and
- require certain holders (such as management or employee holders) to sell their securities only to the issuer.

Both the minority securityholder and control securityholder protections are commonly found in transactions involving private issuers. By contrast, public issuers, whose securities are registered with the SEC, are subject to disclosure requirements and other regulations that provide increased protection for minority securityholders. If a public issuer has a liquid market for securities, minority securityholders have less need for contractual exit rights, since they can simply sell their shares in the market. Moreover, minority securityholders of public issuers may give up certain governance rights in order to avoid treatment as affiliates of the issuer, which gives rise to obligations under the Exchange Act. For instance, a right to a board seat or a tag-along right could lead to obligations under federal securities laws to disclose ownership, purchases and sales of securities under Exchange Act Section 13(d), or even subject the minority securityholder to liability for short-swing profits under Exchange Act Section 16. Consequently, many securityholders agreements often provide for the termination of certain minority securityholder protections in the event the issuer registers with the SEC, whether via an IPO or otherwise.

Counsel should be aware that variations exist from state to state as to how securityholder protections are addressed. The following discussion is based on the authors' experiences with securityholders agreements governed by New York and Delaware law. These agreements are often complex and subject to lengthy negotiations, and may include tax and accounting considerations outside the scope of this discussion.

Glossary of Terms Commonly Used in Securityholders Agreements

Certain terms used throughout our discussion of minority securityholder rights are defined below. The definitions provided here are consistent with those commonly used in securityholders agreements and other agreements or instruments that provide for securityholder rights.

"*Affiliate*" of any person is often defined as any other person (a) that directly or indirectly controls, is controlled by or is under common control with such person, (b) who is an officer, director, manager, employee or agent of, partner or member in, or trustee of, or serves in a similar capacity with respect to, such person (or any of the persons referenced in clause (a) above), (c) of which such person is an officer, director, employee, agent, partner, member or trustee, or serves in a similar capacity, or (d) who is a member of such person's family or a trust for the benefit of such family member or such family member's family.

"*Board*" means the board of directors of a corporation or similar governing body of other types of issuers.

"*Control*" means the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a person, whether through the ownership of securities, by contract or otherwise.

"*Equity kicker*" means a warrant, usually exercisable at a nominal price, or other securities granted as additional compensation to a lender, finance company or service provider.

"*Exchange Act*" means the Securities Exchange Act of 1934, as amended.

"*Exempted issuances*" typically means issuances of issuer's securities that are exempt from certain provisions, such as preemptive and anti-dilution rights, in securityholder agreements and related agreements. Issuances commonly defined as "exempted issuances" include employee stock options under existing compensation plans; public offerings; issuances in connection with acquisitions, mergers or strategic partnerships; and issuances of equity to commercial lenders. The definition may vary depending on the circumstances of the issuer or the investment transaction. For instance, securities issued under a new or expanded employee stock option plan may be included in the definition if securityholders negotiating the definition participate in the adoption of the new plan.

"*Holding period*" has the meaning set forth in Securities Act Rule 144(d) and refers to the length of time a holder of restricted securities must hold such securities before such holder may resell the securities in the public market without registration pursuant to the exemption from regulation under Rule 144. The holding period for restricted

securities held by non-affiliates of an issuer that has been a reporting company for at least 90 days prior to the sale is currently six months, and the holding period for affiliates of an issuer is one year. See 17 CFR 230.144(d).

"*IPO*" means a registered initial public offering. When defined in a securityholders agreement, the term may refer only to those IPOs meeting a certain minimum amount of proceeds, which would indicate more liquidity and a more stable equity base for the post-IPO issuer. Since certain securityholder protections become less important after such an IPO, the securityholders agreement may provide that after an IPO meeting the minimum amount, the agreement will terminate.

"*Issuer*" means the corporation, partnership, limited liability company, trust or other entity that is issuing securities.

"*Market price*" means the current ascertainable price at which a security can be sold (usually a weighted average of the closing sale prices of securities traded publicly over a specified period) or, in the case of a private company, a price for the company as determined by the board or equivalent governing body of the company.

"*Permitted transferees*" means family trusts, family members, corporate affiliates, and other existing securityholders, and also may include limited partners, stockholders or members of a securityholder.

"*Person*" means any individual, corporation, governmental agency or authority, limited liability company, partnership, trust, unincorporated association, or any other entity of any kind.

"*Restricted securities*" means securities purchased in private transactions that are exempt from registration under the Securities Act, and securities held by affiliates.

"*SEC*" means the Securities and Exchange Commission.

"*Securities Act*" means the Securities Act of 1933, as amended.

"*Transfer*" means any direct or indirect transfer, donation, sale, assignment, pledge, encumbrance, hypothecation, gift, creation of a security interest in or lien on, or other disposition, irrespective of whether any of the foregoing are effected with or without consideration, voluntarily or involuntarily, directly or indirectly, by operation of law or otherwise, inter vivos or upon death.

Exit Rights and Prohibitions on Transfer

Investing in an issuer is generally easier than subsequently exiting from the investment. Securities of private issuers are generally illiquid so, short of a sale of the issuer, exits are extremely difficult. Moreover, a sale of the issuer may never occur. Therefore, the priority of the rights of securityholders for exits should be carefully delineated in the securityholders agreement. Exits range from strong rights, such as a put, through tag-along rights to more contingent rights, such as piggyback registration rights and auction rights. The exit rights that investors may receive will depend on several factors, including the nature of the investment, the parties' relative bargaining power, and whether the issuer is (or will likely become) a public company.

In order to enable enforcement of critical exit provisions such as rights of first refusal, tag-along and drag-along rights, securityholders agreements typically include limitations on the direct or indirect transfer of the issuer's securities to anyone other than permitted transferees. The limitations on transfer may include a prohibition of the transfer of securities to certain types of transferees, such as the issuer's competitors (broadly or specifically defined) or a securityholder's divorced spouse. Such transfers could expose an issuer to unfamiliar securityholders with information rights and other rights. Note that, with respect to securityholders that are themselves corporations or other business entities, these limitations may restrict such holders from transferring their own equity securities (as opposed to equity securities of the issuer) to parties other than permitted transferees, since such an indirect transfer of the issuer's stock can have the same effect as a direct transfer. Permitted transferees are generally required to agree to be subject to the transfer restrictions contained in the securityholders agreement.

Redemption and Put Rights

Minority securityholders may require the issuer to redeem or repurchase securities purchased as an investment or received as an equity kicker after certain conditions, such as lapse of time, are met. A right to require an issuer repurchase (also known as a put) is usually granted to lenders for equity kickers and other compensatory equity rights, occasionally for equity investors, and possibly for employees (e.g., in the event of death). A put is generally exercised by the securityholder at its option. Redemption usually applies to preferred securities and entitles the holder to receive a redemption price equal to the preference (which may vary from the purchase price) plus any preferred return. Redemption may be optional, mandatory or automatic. Often an issuer will request a right to repurchase the securityholder's securities (also known as a call) to match a put, especially for equity kickers. The call often will be at a higher price than the corresponding put price.

A strong redemption or put right may turn an equity investment into debt, as determined by the issuer's accountants, which may affect the issuer's balance sheet, credit rating and tax treatment.

The amount of the purchase price for puts or calls is negotiable. For example, fair market value may be determined by the board or by independent valuation experts, or may be a specified multiple of some metric (e.g., five times EBITDA). Determinations of fair market value (or underlying metric) require careful drafting.

Puts and calls related to termination of employment of employee securityholders raise different issues. For example, it is not uncommon for the issuer to have a call right without providing a put right to the employee (which provides no exit right for the employee). The call price payable may be based on a determination of fair market value. The call price can vary depending on the reason employment is terminated; for instance, the call price typically is much lower after termination for cause.

Note that puts and redemptions will be limited if the issuer is unable (because of its financial condition or loan covenants) to fund the put or redemption. Payment of a put may be treated as a fraudulent transfer if the issuer is or becomes insolvent. Consequently, a put is not a bulletproof protection against normal business risk.

Tag-Along and Drag-Along Rights

Tag-Along (or Co-sale) Rights

A tag-along (or co-sale) right provides that minority securityholders may participate in the sales of stock by the issuer's management or control securityholders on a pro rata basis. For example, if a control securityholder agrees to sell a percentage of its securities to a purchaser, the minority securityholder will have a right to sell that percentage of its securities to the purchaser on the same terms. Such tag-along rights usually do not apply to transfers to permitted transferees. Tag-along rights protect minority investors by allowing them to exit their investments at the same time as the controlling securityholders.

The time period for securityholders to exercise tag-along rights should be long enough for the securityholders to evaluate the transaction and to consider exercise of preemptive rights (and to arrange for financing of the preemptive rights). It should not be so long, however, that the potential buyer backs out.

Tag-along rights (and preemptive rights, discussed in Preemptive Rights) may include the option for securityholders already tagging along to sell additional securities if other securityholders do not exercise their tag-along rights. The number of additional shares that can be sold under such option is usually allocated on a pro rata basis among the securityholders exercising their tag-along rights.

Minority securityholders using tag-along rights to sell along with control securityholders may be required to make representations to the purchaser about issuer matters. Such a requirement can be problematic, since minority securityholders may not have as much knowledge about the issuer as control securityholders would have. Therefore, minority securityholders usually seek to limit their liability to the purchaser in the event of a breach of the purchase agreement, for instance by negotiating for provisions that (i) limit the representations that they are required to make to a purchaser to subjects within their knowledge and control, such as title to their securities and

authorization to sell their securities, (ii) share any liability on a pro rata basis with other securityholders, and (iii) limit their maximum liability to the purchaser to their share of the net proceeds. Sometimes minority securityholders negotiate a right to sell their shares to the control securityholder immediately prior to a transaction, so they do not have to enter into any agreement with (or make any representations to) the purchaser.

Tag-along rights must be coordinated with any rights of first refusal. Typically, if a securityholder agrees to sell securities, the other securityholders will first have the right of first refusal to purchase the securities. If the other securityholders do not exercise their right of first refusal, they will then have tag-along rights.

Tag-along rights are particularly important for minority securityholders when there is a strong lead securityholder, such as a private equity sponsor or a founder, which might be able to sell its securities to a strategic investor that may not care about buying the entire issuer.

Drag-Along Rights

A drag-along right allows the control securityholders to require minority securityholders to sell their interests to a third party. If the contemplated transaction involves a vote of the securityholders, the drag-along right may require the minority securityholders to vote in favor of the transaction. A drag-along is an issuer- and control securityholder-friendly right that facilitates the sale of the issuer by eliminating potential holdouts and cutting off dissenting rights of minority securityholders (such as appraisal rights). It is hard for a minority securityholder to argue against drag-along rights because under corporate law, absent agreements to the contrary, issuers can enter into mergers, which would compel the sale by all securityholders. A drag-along right gives the issuer more flexibility in structuring a sale transaction in a form other than a merger, such as a sale of securities or a sale of assets.

Drag-along rights should be limited to arms' length, third party transactions. Without such a limitation, the control securityholder could coerce the minority into selling to an affiliate at an artificially low price.

As with tag-along rights, minority securityholders selling their interests pursuant to a drag-along right should limit the representations and warranties they give to the purchaser. See the discussion of tag-along rights above.

Registration Rights

Registration rights generally enable the securityholder to cause the issuer to register restricted securities (such as equity kickers and other securities acquired in private transactions) with the SEC in order to allow for sales to the public. Registration rights give securityholders more access to the public markets at the issuer's expense (since the issuer would be responsible for registering the securities). Registration rights also enable participation in underwritten offerings, a more secure way to sell the securities, but typically do not guarantee participation in any underwriting. Registration rights are useful only for investments in issuers that are or may become registered public companies with securities that are widely traded. Note that many public companies do not have liquid markets, particularly smaller public companies that are more likely to issue restricted securities in private placements.

The two main types of registration rights are demand and piggyback. Demand rights are stronger and are more likely be negotiated in offerings with strong lead investors. Here are some features of the two types of rights:

- Piggyback Registration: In the event an issuer registers its securities on its own behalf or on behalf of another securityholder, the securityholders will have the right to include their securities (or securities issuable on conversion or exercise of convertible securities such as convertible preferred stock, convertible debt, options or warrants) in such offering on a pro rata basis. Issuers tend to deny piggyback registration rights on IPOs, although some equity investors and financial securityholders who acquire their securities in connection with debt financings often insist on inclusion in an IPO.
- Demand Registration: Securityholders, at specified times (for example, once or twice a year commencing a specified number of months after an IPO), may require the issuer to register a minimum dollar amount of the securityholders' securities. Usually, if the issuer is eligible to register securities on Form S-3, the securityholders also will have the right to demand a specified number of Form S-3 registrations per twelve-month period. As noted above, a demand registration right is more investor-favorable than a piggyback

right, especially if the demand right includes priority in underwritings. If the issuer is a private entity, it usually will not make demand registration rights available until after it has gone public.

Registration rights can be included in a securityholders agreement or a separate registration rights agreement. The registration rights provisions should address:

- The length of time the required registration statement must remain in effect;
- Standard underwriters' cutbacks (e.g., if the amount of securities to be sold by the securityholder has to be limited at the request of the underwriter in order for the offering to be successful);
- Priorities for inclusion in the registration relative to the issuer or other participants in the registration (such as the issuer, management or other securityholders);
- Listing on exchanges;
- Notice of suspensions;
- Mechanical provisions to facilitate simultaneous exercise of convertible securities and sale in the offering;
- Indemnification by the issuer;
- The right or obligation to participate in an underwriting if available;
- The right, if any, of the securityholders to participate in the choice of underwriter; and
- Minimum requirements for offerings.

The period a registration statement must stay in effect is often limited to the Rule 144 holding period applicable to the securities held by the securityholders with registration rights. Form S-3 registrations can be kept evergreen so selling securityholders can sell into the market from time to time—a valuable right, especially if the securities are not underwritten.

Issuers and control securityholders usually are reluctant to grant registration rights. Registration is costly and can be a lengthy, distracting process that may require the issuer to disclose vital information to competitors and customers. Moreover, a public issuer and its principal securityholders may seek to limit supply of the issuer's securities to the market to avoid downward pressure on the issuer's stock price. Also, an issuer can strengthen its balance sheet (or obtain critical capital needed to operate) by issuing new equity and does not usually want to sacrifice or reduce that possibility by giving securityholders the right to dilute the market by selling shares in competition with the issuer. Consequently, issuers and control securityholders prefer to restrict minority securityholders' access to the public markets.

If registration rights are granted to holders as part of an investment transaction, the issuer and underwriters generally require securityholders to "lock up" their securities for a period before and after public offerings by the issuer, usually in a separate agreement entered into prior to (and as a condition of) the transaction. In a lock-up, the holder typically agrees not to, directly or indirectly:

- Offer, sell, agree to offer or sell, solicit offers to purchase, grant any call option or purchase any put option with respect to, pledge or otherwise dispose of the subject securities;
- Establish or increase a "put equivalent position" or liquidate or decrease a "call equivalent position" with respect to the subject securities (in each case within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder); or
- Otherwise enter into any swap, derivative or other transaction or arrangement that transfers to another, in whole or in part, directly or indirectly, any of the economic consequences of ownership of the subject securities, whether or not such transaction is to be settled by delivery of the subject securities, other securities, cash or other consideration.

Lock-ups help issuers and underwriters control the flow of issuer securities in the marketplace. Securities markets, like all markets, depend on supply and demand, and the issuer and underwriters typically want to limit supply after the large number of securities sold in a public offering were added to the supply. In addition, many holders of restricted securities may be insiders, such as members of management or large holders (which are obligated to report sales), and the underwriters may feel it is adverse to the success of an offering if the market perceives insiders exiting the securities. Since the holding period of restricted securities required under Rule 144 prior to

public sale for non-affiliate securityholders is only six months, the disadvantages of a lock-up provision may outweigh the value of the registration rights.

Note that in transactions in which securityholders make a private investment in a public issuer (commonly known as a private investment in public equity, or PIPE), the issuer often agrees to register the sold securities shortly after closing (usually within 30 to 90 days), with cash penalties for delay. This is generally a stronger right than demand registration rights, since the registration enabling a PIPE investor's exit is predetermined, occurs shortly after closing, and generally is not subject to conditions.

Other Exit Rights

Buy-Sell Agreements

A buy-sell agreement enables a securityholder to offer to purchase the securities of another securityholder on specified terms, and the other securityholder has the choice either to sell the securities on the terms offered or to purchase the securities of the initiating securityholder on the same terms. Some buy-sell agreements may provide for a formula to calculate the purchase price when the buy-sell is exercised. Buy-sell agreements by their nature benefit the securityholder with more capital and consequently are not common.

Buy-sell agreements are most appropriate as a mechanism to resolve deadlocks (for instance, in the case of an issuer that is owned 50-50). A buy-sell could also be triggered if the issuer turns down a bona fide purchase offer from a third party.

Time periods for exercise of buy-sell rights, if long, are cumbersome and, if short, may not give the non-initializing securityholder enough time to procure necessary financing for the purchase. Since buy-sell rights usually apply to larger blocks of securities, the time periods usually run from thirty to ninety days (unlike shorter periods for preemptive rights or rights of first refusal), because of the greater difficulty of financing the purchase of a high percentage of the issuer.

Auction Rights

Securityholders agreements may provide that securityholders have the right, under certain circumstances, to require the issuer to conduct an auction to sell itself. For instance, an auction right may be triggered if the issuer cannot perform on a put right due to loan covenants. The auction right will specify the nature of the issuer's auction obligations, which may be as simple as using reasonable best efforts to put itself up for sale or may include details about advertising and other steps the issuer must take during the auction process. Often the auction right may enable an investor to cause an issuer to engage an investment bank with specified credentials to conduct the auction. Auction rights typically cannot be triggered until a certain period of time after the date of the securityholders agreement elapses or certain benchmarks are missed.

An auction in principle removes any concerns about computation of the fair market value of the issuer that is often inherent in other exit rights. Note, however, that the ultimate determination of fair market value for purposes of an auction right generally rests with the issuer's board of directors. The auction right typically reserves the right of the issuer's board to reject a bid if the board deems the bid to be too low or otherwise not in the best interests of the issuer's stockholders, and even a diligent auction may not turn up a buyer. Thus, an auction right does not compel the sale of the issuer.

As in any auction process, the issuer's board should ensure that the required auction is well managed, with clear and objective processes in place. A rushed, disorganized auction may look like a sale in distress, and a potential buyer in an illiquid market may take advantage. As noted above, an auction right is not a required sale at a specified price, and (other than in the case of a limited liability company with a strong fiduciary waiver provision) the issuer's board, general partner or management committee, as fiduciaries for the issuer's equityholders, may be obliged to turn down what it deems to be an inadequate offer. Consequently, an auction right is a weaker exit right than a put.

Rule 144 and 144A Rights

Rule 144 under the Securities Act provides an exemption from registration for sale to the public of certain minority interests that are restricted securities, generally commencing after a holding period of six months for non-affiliates of an issuer that has been a reporting company for at least 90 days prior to the sale. Rule 144A provides a safe harbor for the private resale of securities to "qualified institutional buyers" (as defined in the rule).

The availability of current information about the issuer is one of the conditions for qualifying for the exemption under Rule 144A and, at least initially, under Rule 144. Accordingly, securityholders who acquire their interests as restricted securities in a Rule 144 or 144A transaction typically require the issuer to maintain filings with the SEC on a current basis. This requirement should survive termination of the relevant securityholders agreement.

Cashless Exercise

Warrants or options to purchase securities often provide for cashless exercise—that is, exercise by surrender of a portion of the warrants or options rather than by payment of additional consideration. In a cashless exercise, the warrant or option holder receives the number of underlying securities equal to the number of shares for which the warrant or option can be exercised times the value of the warrant or option (where the value is the difference between the underlying securities' market price and the exercise price of the warrant or option), divided by the market price. As an example, if a holder of warrants exercisable to purchase an aggregate of 10,000 shares of common stock with an exercise price of $10.00 per share engages in a cashless exercise of the warrants at a time when the common stock has a market price of $25.00 per share, by surrendering 4,000 of such warrants (that is, the number of warrants having a value for this purpose of $60,000, since each warrant is now worth $15), then the holder will use the $60,000 of value surrendered to exercise the remaining warrants to purchase 6,000 shares of common stock.

Put another way, the holder exercises the warrant for all 10,000 shares of common stock and pays for the exercise by surrendering 4,000 of the shares received, which, at the time of the cashless exercise, have an aggregate market price of $100,000.

Cashless exercise enhances the exit rights of the warrants or options by limiting the need for further investment. Moreover, since no additional purchase price is paid, cashless exercise also shortens the holding period for qualification of sales under Rule 144. With cashless exercise, the holding period for Rule 144 commences on the date of issuance of the warrants or options, rather than exercise. Thus, in the above example, if the warrant was acquired more than six months prior to the date of exercise, and the holder is not an affiliate of the issuer, the holder may sell the shares received upon exercise to the public immediately under Rule 144.

For purposes of calculating the value of the warrant or option in a cashless exercise, the market price of a publicly traded stock will often be defined as the average of the closing sale prices of the common stock over the ten trading days (or other period) preceding the exercise (or the weighted average price based on volume over a similar period). The value of private company shares will usually be determined by the issuer's board.

Preferences

Preferred stock issued by corporations or similar securities issued by other issuers may contain provisions that allow the holders to force the issuer to redeem the shares or take other action that results in an exit from the investment. For instance, failure to pay preferred dividends may result in the preferred holders obtaining more board seats. Preferences and related waterfalls are often complex, and are beyond the scope of this article.

Mandatory Tender

A mandatory or required tender provision provides that, if a securityholder acquires more than a certain percentage of an issuer's securities and thus becomes a control securityholder, the securityholder is required to purchase the balance of the issuer's outstanding securities. This provision is not common in the U.S., but is embedded in the law of some foreign jurisdictions, such as the United Kingdom.

Anti-Dilution Rights

The word "dilution" has several meanings in the context of investing and securityholder rights. For purposes of disclosure in prospectuses for public offerings, "dilution" has been defined by the SEC as the reduction in tangible net book value. To most securityholders, however, dilution means the reduction of percentage ownership due to a subsequent sale of issuer securities at a lower price, even if such sale increases the tangible book value per share. Especially in early stage companies that underperform or need capital very quickly, later investors may demand better terms than earlier securityholders (a "down round"), which may have the effect of diminishing the value of the earlier securityholders' investment. In order to sustain investor interest in an illiquid market, investors prefer to discourage down rounds and will negotiate to ensure that the dilution caused by such down rounds is borne by the insiders instead of the investors. These protections against dilution can take different forms, but the common goal is to enable investors to maintain their proportionate ownership in the issuer, generally at the expense of other securityholders.

Preemptive Rights

The securityholders may bargain for a preemptive right, which would be triggered if the issuer issues additional units of any class of equity securities or convertible securities. A preemptive right entitles the securityholders to purchase, on the same terms as the issuance of additional units, the number of equity securities required to maintain their respective percentage ownership positions in the issuer. This right is a useful protection from dilution for securityholders who will continue to have capital available for investment in the issuer.

A preemptive right is often limited to a period within a specified number of years after closing of the securityholders' purchase and ends prior to an IPO. Also, the right generally will not be triggered by exempted issuances. As discussed in the Glossary, “exempted issuances” typically include employee stock options under existing compensation plans; public offerings; issuances in connection with acquisitions, mergers or strategic partnerships; and issuances of equity to commercial lenders.

Preemptive rights are default rights under the corporate law of many states (but not New York or Delaware) in that the rights will automatically apply if not specifically excluded in the issuer's certificate of incorporation. Preemptive rights can also be explicitly included in the certificate of incorporation. The certificate of incorporation is a public document; accordingly, preemptive and governance rights put in the certificate of incorporation will be open to the public. The certificate of incorporation can be changed only with formal stockholder action (rather than a private amendment to a securityholders agreement). Limited liability companies typically have preemptive rights only if provided in the limited liability company’s operating agreement (a private document).

The time period for securityholders to exercise preemptive rights should be long enough for the securityholders to evaluate the transaction and to arrange for any necessary financing to exercise the preemptive rights, usually ten to thirty days. The longer the period, the more likely other potential purchasers of the issuer's securities may lose interest.

Rights of First Refusal/Offer

A right of first refusal obligates a securityholder who wishes to sell its shares to a third party (other than to a permitted transferee) to offer them first to the issuer or the issuer's other securityholders on the same terms as the third party's offer. The issuer and the other securityholders will have a period of time to decide whether they want to purchase the selling holder's shares on those terms. If the issuer or the other securityholders decide to purchase the shares, then the selling holder must sell the shares to them. If the issuer or the other holders decline to purchase the shares, then the selling holder may sell the shares to the third party. A variation of the right of first refusal is the right of first offer, in which the selling holder does not have to obtain a third party offer, but can request an offer from the issuer or the other securityholders. Rights of first refusal and first offer usually expire at the time of an IPO.

Strictly speaking, rights of first refusal and first offer provide an opportunity for securityholders who continue to have capital available for investment in the issuer to increase their ownership, rather than protection from dilution.

These rights also allow issuers and existing security holders to prevent sales to undesirable potential securityholders, such as competitors, adverse litigants or other potentially difficult investors.

Note that restrictions on resales can be adverse to the securityholder because they can slow down the sale process; however, this disadvantage is balanced by the opportunity to purchase securities sold by other securityholders. The time period for securityholders to exercise rights of first refusal should be long enough for the securityholders to evaluate the transaction and to arrange for any necessary financing to exercise the rights of first refusal, usually ten to thirty days. The longer the period, the more likely other potential purchasers of the issuer's securities may lose interest.

The right of first refusal must be coordinated with any tag-along rights.

Anti-Dilution Adjustments for Convertible Securities

Structural Anti-Dilution Provisions

State corporate laws usually contain anti-dilution protections for holders of common stock in the event of stock splits, mergers, reclassifications, reorganizations and other potentially dilutive structural transactions. Comparable protections are not generally available for holders of convertible securities, however, and therefore anti-dilution mechanisms must be set forth explicitly in securityholders agreements or the terms of such securities. Adjustments to the number of shares covered by a warrant or option as a result of such a dilutive structural transaction should be matched explicitly with equitable adjustment in the exercise price.

Price Anti-Dilution Provisions

In addition to the standard anti-dilution adjustments discussed above, convertible securities often provide for anti-dilution protections based on the price of subsequent issuances of additional common shares or convertible securities. Price anti-dilution protects a securityholder from paying a higher price shortly before new investors invest at a lower price. In general, adjustments in conversion prices due to subsequent issuances at lower prices will automatically increase the number of shares issuable upon conversion of convertible securities, since the adjusted price is the measure for determining the number of shares issuable upon conversion. Adjustments to the exercise prices of warrants as a result of price anti-dilution should be matched explicitly with an equitable adjustment in the number of shares covered. For instance, a warrant or option to purchase 100,000 shares at $10.00 per share should provide that if the exercise price is reduced pursuant to the adjustment, the number of shares will go up so the warrant holder can always purchase $1,000,000 of the issuer's securities. Similar provisions in convertible preferred or debt typically are not required since such securities entitle the holder to convert the entire dollar amount of the securities at the conversion price as adjusted.

Price anti-dilution formula protection also can be available for common stock investments (in addition to pre-emptive rights), but this is rarer, particularly because securityholders that purchase common stock are not generally asked to make (or encouraged to make) a future investment decision, e.g., to exercise a warrant or to convert another security.

Note that the anti-dilution adjustments that benefit one group of securityholders dilute the interests of the other securityholders (often the founders or earlier round investors).

Price anti-dilution provisions are often expressed in complex formulas. One common drafting issue relates to whether anti-dilution refers to a conversion rate (how many shares of common stock per dollar of convertible debt or preference) or a conversion (or exercise) price. These provisions may be limited to a specified time period or maximum amount of adjustment. When drafting or reviewing anti-dilution provisions, it is wise to run a few examples through the formulas. Common price anti-dilution protections include:

- Ratchet Anti-Dilution: The conversion price or exercise price of the convertible security (usually for conversion into common stock) will be subject to reduction to the per share purchase price of newly issued

common stock or new convertible securities convertible into common stock (other than exempted issuances), taking into account all components of the financing.

- Weighted Average Anti-Dilution: If the issuer issues securities (other than exempted issuances) below the conversion price or exercise price of outstanding convertible securities (for purposes of the calculation, the reference price), such conversion price or exercise price is reduced on a weighted average basis, for instance, by multiplying it by the ratio of (A) the sum of (1) the actual consideration received in the issuance plus (2) outstanding shares (fully diluted for broad-based weighted average) multiplied by the reference price, divided by (B) the total number of shares outstanding (fully diluted for broad-based weighted average), after giving effect to the issuance, multiplied by the reference price. The computation of fully diluted shares can vary, but should include all shares issuable upon exercise or conversion of outstanding convertible securities and securities issuable under authorized equity incentive plans. A narrow-based weighted average may exclude convertible securities, which mathematically increases the effect of the anti-dilution provision. Anti-dilution provisions for warrants must specify whether the number of shares issuable on exercise increases proportionally as the exercise price decreases.

- Percentage Anti-Dilution: Some securityholders may require that their percentage interest will not be reduced by any subsequent financings, allocating all of the dilution to the other securityholders, such as founders, management and earlier investors. An investor who receives nominal price warrants as an equity kicker or wants to impose a cost on other classes of securityholders (such as other warrant holders or a sponsor) if the issuer fails to achieve its business plan on budget may prefer this form. This protection is triggered irrespective of the price of a new issuance. Depending on the price and the size of the new issuance, percentage anti-dilution may give a greater benefit to the investor than ratchet anti-dilution would provide.

- Market Price/Benchmark Price Anti-Dilution: A market price anti-dilution provision is similar to the other purchase price anti-dilution methods, but only applies if securities are sold below their market price. Market price anti-dilution provisions are rarely used, for several reasons. First, the issuer's board would be reluctant, for fiduciary reasons, to admit to selling securities below market. Second, it is hard to determine the market price of securities of private issuers, and private issuances of securities of public issuers are usually made at a discount to the public market price, which may fairly represent the effect of restrictions on resale. Third, selling securities below market may trigger adverse tax and accounting consequences. Thus, market price anti-dilution provisions are not typically valuable to minority security-holders. Price anti-dilution provisions for warrants exercisable at a nominal price work better if coupled with a benchmark price anti-dilution provision, where the number of shares or units issuable upon exercise or conversion of the convertible securities increases (either on a ratchet or weighted average basis) if the issuer issues securities below a fixed (benchmark) share or unit value (rather than the exercise price). A benchmark price may be fixed by negotiation and is usually based on the market price of the underlying security at the time of the transaction.

- Cashless Exercise: Provisions in warrants or options for cashless exercise may provide price anti-dilution by providing floors or other calculations for the valuation of the security issuable upon exercise of the warrants. For instance, a calculation for market price that yields a relatively high deemed value despite low actual market prices increases the difference between market price and exercise price, which has the effect of reducing the exercise price and can be costly to an issuer. A market price of a publicly traded security determined on only one or a few trading days' closing prices instead of over a longer period or on a volume weighted average is likely to be favorable to the investor since the investor can pick an auspicious time to exercise the right.

Ratchet, weighted average, and percentage anti-dilution provisions force other securityholders to bear all dilution for a down round (that is, an offering at a lower price). These rights (especially ratchet and percentage anti-dilution), by reshaping the capital structure, may make subsequent financings very difficult (or in some cases mathematically impossible), in which case the securityholder holding such rights will have a seat at the table to negotiate.

Equity interests in limited liability companies or limited partnership can also be protected by ratchet, weighted average, or percentage anti-dilution provisions, whether the equity is divided into units or maintained as percentages.

Other Anti-Dilution Considerations

Preferences and Waterfalls in Preferred Stock

Conventional preferred stocks (or the equivalent in other kinds of issuers) may resemble debt, with a fixed return. Preferred securities that are convertible into, or otherwise linked with, interests in residual common equity need anti-dilution protection. Investors may protect their investments against dilution by negotiating preferences on liquidation and distributions.

Preferences can be structured to resemble residual equity, for instance, by providing a preference sufficient to deliver a specified internal rate of return or a multiple of the initial investment. These structures arguably bypass conventional price anti-dilution provisions. See "Death Spiral Issuances and Other Dilutive Transactions" below.

Death Spiral Issuances and Other Dilutive Transactions

Issuers that are desperate for capital may resort to selling highly dilutive securities that can finesse price anti-dilution protections. For instance, death spiral convertible debt (usually in a public company) provides for reductions of the conversion price based on the public market price, which price invariably goes down as the death spiral holder sells into the market. The death spiral holder may profit but the number of outstanding shares increases geometrically, creating a "death spiral" for the stock price. Investors may protect against future dilution by providing in the investment agreement for bars on issuances of securities with conversion prices that vary as market prices change.

Minority Participation in Issuer Governance

In addition to protecting the financial aspects of their investment through exit and anti-dilution rights, minority securityholders often seek to have a "seat at the table" in the governance of the issuer. The minority securityholders may request board membership or observation rights, supermajority voting requirements or other voting rights, and rights to access business and financial information about the issuer. The securityholders may also negotiate a veto right or other supervisory right over executive compensation and transactions with affiliates, which can constitute a form of protection from dilution. The securityholders' rights under state corporate law, even for access to information, are relatively weak. Therefore, negotiating contractual governance and information rights is essential for the minority securityholders to be more informed about the issuer, have a say in the direction of the issuer's business, and, in the process, preserve the value of their investment.

Director Rights

Minority securityholders often negotiate for a right to appoint a specified number of directors to the issuer's board. This right will sometimes also extend to membership on certain committees, such as the executive committee, audit committee and compensation committee. Board observation rights may be provided to a securityholder in addition to, or as an alternative to, board membership.

In negotiating director or board observation rights, the issuer and the securityholders should consider:

- <u>The duration of the right</u>: Director and observation rights typically terminate upon the occurrence of certain events, such as an IPO or the equity beneficially owned by such minority holders falling below a specified percentage of the issuer's equity.
- <u>The size of the securityholders' representation on the board</u>: How many directors the minority securityholders will be able to appoint will depend on the size of the issuer's board, the securityholders' percentage ownership, and the parties' relative negotiating power.

- Events triggering director/observer rights: The right to appoint directors or board observers can be made contingent upon the occurrence or non-occurrence of certain events. For example, the terms of preferred stock often include a right to elect directors to the issuer's board if dividends are not paid currently for a specified period, usually varying from six months to two years.

Note that the effect of a director right will vary if higher percentage votes of the directors are required for certain actions, such as major corporate transactions. A single director has little power unless there is also a requirement of a favorable vote for that director (or a veto right) for certain actions, such as major transactions, executive compensation, or transactions with affiliates.

Minority securityholders may also require appointment of independent directors (not necessarily chosen by the minority securityholders), in some cases with veto rights on major transactions, executive compensation, or transactions with affiliates. Issuer management will resist participation in control by minority directors or even independent directors as costly, cumbersome or unnecessary.

Board membership imposes time obligations as well as certain liabilities and other obligations, including fiduciary obligations to all securityholders, control liability, and reporting obligations (and potential short swing trading liabilities) in public issuers. Therefore, directors designated under securityholders agreements should ensure they are covered by the director and officer insurance policies maintained by the issuer for their management (or have the issuer purchase such policies) and have the issuer indemnify them in connection with any liabilities that may arise from their service on the board.

Voting Rights

Minority securityholders often negotiate for supermajority voting requirements (or approval by separate classes of securities, if applicable) for major corporate actions by the issuer, such as equity financings, mergers, sales of substantially all assets, amendments to the certificate of incorporation and annual budgets, or for transactions with management and affiliates. Since it may be cumbersome to obtain securityholders votes, these voting rights usually only apply to major corporate actions, restrictions on executive compensation or transactions with management and affiliates, and work less well for operational matters, such as budgets. These voting rights may be found in preferred stock terms (even in public companies) or securityholder agreements.

Right to Information

Non-public issuers will often be required to agree to provide timely quarterly and annual financial statements. The time specified for providing reports often tracks the reporting requirements for small public companies, such as 45 days after end of a quarterly period (usually unaudited) and 90 days after the end of the annual period (usually audited). Other information requirements (such as budgets and forecasts) are more deal-specific. The issuer generally requires securityholders to keep information confidential.

Executive Compensation and Transactions with Management

Minority securityholders often seek either voting rights or director rights to supervise executive compensation or transactions with management and affiliates. The securityholders agreement should provide that the minority securityholders or their designated director (or an independent director) can veto executive compensation or transactions with management and affiliates, or at least bar transactions on anything other than an arms-length basis.

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