EDUCATIONAL NOTES FOR PREFERRED SHARE TERM SHEET
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The educational material below will walk the reader through a section-by-section description of each part of the standard clauses that can be part of a preferred share term sheet. It will give the rationale and appropriate use of each section, some examples and in some cases a short case study that seeks to clarify the use and importance of certain sections in a preferred share term sheet. Note in this ‘notes’ section we are only addressing the specific ‘preferred’ terms, for all other terms please refer back to the educational notes for the Common Shares Term Sheet.

In very simple terms, Preferred Shares give the investor rights that the other shareholders in a company, most likely founders and earlier investors, do not enjoy. They will include a liquidation preference and some or all of the elements discussed here, like dividends, conversion rights, voting rights, certain protective rights and redemption rights. Since this type of transaction gives the investors special rights it is usually the investor or investor group that will ask for the preferred terms in order to mitigate risk and enhance returns. They will then determine what clauses of the ones listed here they want to see reflected in a specific term sheet.

5. Liquidation Preference

In the event of any voluntary or involuntary liquidation, dissolution or winding-up of the Corporation, the holders of [Class AA] preferred shares (the “Preferred Shares”) will be entitled to receive in preference to the holders of any other class of shares [1.0]x the Purchase Price plus unpaid dividends on each such share (the “Liquidation Preference”).

Note: a 1x Liquidation Preference is standard but it can be higher

After payment of the Liquidation Amount, the holders of Preferred Shares participate pro-rata with holders of the common shares on an as-converted basis in the distribution of the remaining assets.

The Liquidation Preference is the core element of a Preferred Share deal. It gives its name to the type of shares that are being purchased, in addition to some other special or preferred rights like dividends that are attached to the shares in a way that other (common) shareholders do not have. In
simple terms this is nothing more than a determination of who gets paid first if a company is acquired or listed on a public exchange.

There are two types of liquidation preferences:

**Straight (or non-participating) Preferred Shares** – this liquidation preference is most favorable to a company. Upon the sale of the company, the preferred shareholders are entitled to the return of their entire investment (plus any accrued dividends) prior to the distribution of any proceeds to the common shareholders. Alternatively, the preferred stockholders could choose to convert their preferred stock to common stock and simply be treated the same as the common stockholders.

**Participating Preferred Shares** – this Liquidation Preference is most favorable to the investor. Similar to straight preferred, the preferred shareholders would be entitled to the return of their entire investment (plus any accrued dividends) prior to the distribution of any proceeds to the common stockholders. However, the preferred shareholders would then also be treated like common stockholders and would share ratably in the remaining proceeds – in effect, being paid twice (or “double”). A term sheet would indicate if this participation right is a simple participation (usually 1x) or multiple times. In VC deals it is not uncommon to see a 2x or 3x participation, ie. the investor would get his or her money back two or three times before converting and participating pro-rata in the common share pool.

**CASE STUDY**

In the case of a Halifax tech company, VC’s included a participating preference share condition with a 3X minimum return. The Company was sold. Pref C’s got their 3X plus accrued dividends. They then distributed proceeds to VC’s with A and B pref shares. Then the VC’s pref(s) were treated on an as-converted (into common) basis (the infamous double-dip), and they then enjoyed their pro rata of what little was left. The Founder and common shareholders were left with nothing, from a $20 million dollar all-cash acquisition.

The calculation of the preferred rights get complicated if multiple rounds with a liquidation preference are done, and as seen above, the return to the common shareholders is likely to reduce significantly.

**Note for Founders:** It is evident that the Liquidation Preference works to the benefit of the investor, never to the founder. So in early stage deals this is a clause to be avoided if at all possible. However in Canada there has been an increasing usage of this term, largely building on US practice and its omnipresence in VC deals. A 1X or ‘simple’ or ‘light’ Liquidation
Preference is increasingly common in early stage deals and may be the way to go in order to secure a round, in particular if it is to be offered to US-based investors at the same time. A round that will include US-based investors but without preferential rights is unlikely to succeed.

6. Conversion Rights

- (a) The Preferred Shares will be convertible into Common Shares at any time at the option of the Investors at an initial conversion rate of one Common Share for each Preferred Share, subject to adjustments for anti-dilution and subject to proportional adjustments for stock splits, stock dividends, and similar events.

- (b) Preferred Shares will be automatically converted into Common Shares, at the then applicable conversion rate, (i) upon the closing of a firmly underwritten public offering of Common Shares of the Corporation at a per share price not less than [3.0]x the Purchase Price (as adjusted for stock splits, dividends and similar events) and for a total offering of not less than $[30] million (before deduction of underwriters commissions and expenses) or (ii) if the holders of at least [66⅔]% of the then outstanding Preferred Shares vote in favor of such conversion.

Optional

- (c) If within three years of the last Closing Date of this Offering the Corporation issues securities having rights, privileges or priorities that are senior to the rights, privileges or priorities of the Preferred Shares, the Investors will be entitled to exchange their Preferred Shares for such number of senior securities as would have been issued to the Investors if they had originally purchased such senior securities for the total amount raised under the Financing.

Closely tied to the Liquidation Preference are the Conversion Rights which give the investor the right to convert his or her preferred shares to common shares. Usually this right is either optional (at the option of the preferred owner) or mandatory (mostly when a company lists its shares on public exchange). Note that the option given in (c) can be detrimental in closing future rounds of financing.

Good Practice & Note for Founders: None, the core conversion rights are standard. However when investors insist on having the right to convert to the same class of shares in a future round of financing as outlined under (c) it may cause some issues in trying to secure future financing. While this right protects investors in a current round they need to be aware of the potential roadblock they create for a future round.
7. Voting Rights

The holders of Preferred Shares will be entitled to receive notice of and attend any meeting of the shareholders of the Corporation and will be entitled to vote together with the Common Shares as a single class.

or

The holders of Preferred Shares will vote together with the Common Shares on an as-converted basis as a single class, and not as a separate class, except (i) holders of a majority of the then outstanding Preferred Shares will be entitled to elect one member of the Board, (ii) as provided under “Protective Provisions” above or (iii) as required by law.

The section on voting rights usually outlines how Preferred Shareholders can vote their shares and if their ownership gives them the right to appoint one or more directors to the Board of the company.

Good Practice & Note for Founders: None, this is fairly standard.

8. Price Protection Rights

Also Known As: Anti-Dilution

If the Corporation issues additional securities at a purchase or conversion price less than the Purchase Price (subject to customary exclusions), the conversion price of the Preferred Shares will be subject to a [full ratchet / weighted average] adjustment to reduce the dilution of the Investors based on the price or conversion price at which the new securities are issued.

There are two common ways to adjust the share allocation in a scenario like this: (1) weighted average (broad-based or narrow-based) and (2) full ratchet. See notes.

Price Protection can appear both in Common Share Term Sheets and Preferred Share Term Sheets.

Note for Founders: Please refer to the educational notes under Common Shares.

9. Dividends

The Preferred Shares will accrue dividends as may be declared by the Corporation. No dividends are contemplated at present.

or:
The Preferred Shares will carry an annual preferential cumulative dividend of $[6 – 8]$% of the Purchase Price (the “Preference Dividend”). Once the Preferential Dividend is fully paid, the holders of Preferred Shares have the right to receive, pari passu with the holders of Common Shares, on an as-converted basis, any other dividends declared by the Corporation.

Note that if dividends are agreed to be part of the deal they will accrue and become part of the amount that will convert to Common Shares as outlined in Section (2) above.

Preferred Shares usually attract a Dividend in the $5 – 10$% range that will can be paid on on a regular basis or accrue on a non-cumulative or cumulative basis over time and will be paid out upon a liquidity event to the shareholders. They are inserted by investors to ensure at least a minimum rate of return, however in early stage angel-led financings they are relatively rare. It is mostly a condition imposed by institutional investors.

Some preferred share term sheets may indicate that dividends are not to be paid to common shareholders.

**EXAMPLE**

‘The Company may not pay dividends on its Common Shares unless the Series Seed Preferred receives dividends equivalent to dividends paid on the Common Shares. The Series Seed Preferred will participate with the Common Shares on an as-converted basis’

**Note for Founders:** While standard in institutional rounds, not all Preferred Term sheets will include dividend or interest attached to the investment although they tend to appear more often in Canadian preferred deals. For founders it will be important to note that even though a range of $5-10$% may not seem much, it tends to add up if the dividends are accrued over time and converted at a future point in time. The dilutive impact will be significant. When modelling financial projections founders will have to make sure to include dividends and interest payments under all instruments that convert and assess what the impact is on common shareholders in the future.


In addition to the other modifications required to reflect this term sheet, the [Amended] Shareholders’ Agreement of the Corporation will include the requirement that approval of holders of at least $[66\frac{2}{3}]$% of the then outstanding Preferred Shares is required before any of the following actions are taken (with respect to the Corporation or its subsidiaries):
• (a) amending the articles or by-laws of the Corporation;
• (b) creating or authorizing the creation of or issue any other security convertible into or exercisable for any equity security, having rights, preferences or privileges senior to or on parity with the Preferred Shares, or increase the authorized number of Preferred Shares;
• (c) declaring dividends or returning capital;
• (d) redeeming or repurchasing any of the Corporation’s shares (except upon the departure of a founder and or a key employee);
• (e) making loans or guaranteeing debts (except in the ordinary course of business);
• (f) incurring debt if the Corporation’s aggregate indebtedness would be more than $[●];
• (g) entering into a non-arm’s length transaction;
• (h) entering into a sale of the Corporation or business combination transaction (including an amalgamation or plan of arrangement);
• (i) voluntarily liquidating or dissolving the Corporation; and
• (j) selling (or otherwise encumbering, disposing of or transferring) all or substantially all of the Corporation’s assets.

**Note for Founders:** This section will have a serious impact on how you run your business on a day-to-day basis and it will impact the room you have to make certain decisions. Given that these decisions have an impact on the position of Investors it is wise to negotiate each and agree on numerical values for each where appropriate when entering into the final Shareholders Agreement. Note that they also appear in Common Share Term Sheets but that in Preferred Share Term Sheets they may be expanded and become more onerous for the company.

**B – EXTENDED TERMS**

**B1. Redemption Rights**

If the Corporation has not been sold or listed on a public stock exchange after 5 (five) years following the Closing Date, each Investor will have the right at its option, from time to time, and subject to applicable law, to require the Corporation to redeem some or all of its Preferred Shares. Upon each such redemption the Corporation will pay the holder of such Preferred Shares being redeemed the higher of: (i) an amount equal to the Purchase Price
plus declared and unpaid dividends; and (ii) an amount equal to the then fair market value of the Common Shares issuable upon conversion of such Preferred Shares. [Note: to avoid the discussion about the difference in value between a Common Share and a Preferred Share]

Optional:

To the extent that the Corporation’s available cash flow does not permit a full redemption, the remainder will be paid in the form of a one-year promissory note to each unredeemed holder of Preferred Shares bearing interest at a rate of [10]% per annum, and the holders of a majority of Preferred Shares will be entitled to elect a majority of the Corporation’s Board of Directors until all principal and interest owing under such notes are paid in full.

Alternatively the Corporation can be given the same right to redeem the Preferred Shares at its sole option. This is a negotiation item.

This is the right of current shareholders to redeem their shares or a portion thereof at a certain future date (typically 5 years) at the market valuation of the company. It is seen to promote alignment of founders and investors to drive the company to an exit. Reduces the risk of no ROI to the investor and the risk of the founders developing a “lifestyle” company that works for the founders but not the investors. Again, this is somewhat rare in angel stage financings, it is mostly a condition imposed by institutional investors.

Typical venture deals with redemption rights will usually provide for a right to force the sale of the company if it cannot pay the redemption price and then all the shareholders undertake to sale the company. However this is difficult to enforce (i.e. selling the company without the support of the founders).

Note for Founders: Even though rare in early stage Canadian deals, there is a trend where investors want to insure themselves against the potential of being locked into a deal without ever seeing an exit. While this is sound rationale, founders will feel this clause as a sword hanging over their heads and will raise all sorts of concerns, ranging from the ability of the company to fund such a future obligation to the impact it may have on its balance sheet and thus the company’s ability to attract investment or bank financing before the redemption right is exercise.