White Paper Report:

Delaware Blank Check Preferred Stock

The Directors' Trump Card for Attracting Early Investors, Maintaining or Gaining Control, Rewarding Key Participants, Going Public and Avoiding Bankruptcy

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Every Delaware General Corporation must have one class of common stock, but the corporation can have a second class of stock (or more) with customized terms for the different classes. The most popular second class of stock is called preferred stock because it can contain terms, negotiated between the Board of Directors and the recipient, that are preferred over the rights of common stockholders. Delaware's brand of preferred stock is so powerful and flexible as a business tool that it is known to the top U.S. and international corporate lawyers as "Delaware Blank Check Preferred Stock."

If you're thinking of starting a business, raising capital and going public, or if you're already there and ready to proceed, you need to know about the potential power this tool can offer you.

Why would anyone want more than one class of stock in a Delaware corporation? Common stock has two fundamental characteristics that are written in the Delaware General Corporation Law and are mandatory. The first is that every share of common stock carries one vote. If you own 100 shares, you have 100 votes to cast on all matters presented for votes at stockholder meetings. The second is the right to your pro-rata share of any dividends issued by the Directors to the common stockholders. If the total dividend is $1,000,000 and you own ten percent of the total outstanding shares of common stock, you are entitled to 10% of the $1,000,000. You cannot, by law, get cheated on those two counts.

After all, common stockholders own the company. They have invested their money in the company and have a keen interest in their share in the profit. If the company does not see a profit, common stockholders get nothing. If the company sees a profit, the Board of Directors decides where the profit is to be spent, invested and/or distributed. A stockholders' dividend is a distribution of profits. If the Board of Directors saves and/or invests all the profit, with the best of intentions, and does not regularly declare a dividend, the stockholder has little recourse. If the Board of Directors decides not to declare a dividend, the shareholders get no share of the profit. In the case of Apple (until recently), shareholders got no dividend but they did get an extreme increase in the valuation of their stock, so everyone was happy. In other cases, like Wal-Mart, the shareholders have been given a distribution of profit in the form of a dividend for many consecutive years, and each year that dividend has increased. There is no right or wrong in these examples; this is just how it works. The same is true for any Delaware General Corporation.

Entrepreneurs admit there are extreme challenges that can occur in the life of a company, and often it is wise to negotiate with new investors, the founder or creditors for better terms than the common stockholders receive. Delaware Blank Check Preferred Stock can do all this and more.

In fact, owners of Delaware Blank Check Preferred Stock can collect dividends before common shareholders and, unlike common shareholders, can be guaranteed a security interest in the company's assets, equipment and Intellectual Property. If it is properly stated, they can even be guaranteed a percentage of gross sales, before any money is allocated toward paying bills or paying dividends to common shareholders (ergo the subtitle, The Trump Card).

How does an inspired entrepreneur obtain this silver sword? There are three situations to consider:

1. If you have not yet formed a Delaware Corporation to pursue your vision, then be sure to specify it when you initially form your company. This is when it is least

expensive to obtain. You don't need to specify the specific terms of the preferred stock when forming a company, just the number of shares and a nominal par value. You can specify the terms for each series of your blank checks as you use them. Just be sure to declare the preferred stock in the beginning so you can use it later.

2. If you already have a Delaware General Corporation with only one class of stock, then your Board of Directors, with shareholder approval, can authorize a second class of preferred stock. If you can't get your Board to approve the second class of preferred stock, or if you can't get your stockholders to approve it, you're effectively blocked and thus powerless. However, once the shareholders approve the authorization of the stock, the Board is free to negotiate the terms in order to attract capital, inspire influencers or make strategic alliances using the Blank Check Preferred Stock as their own form of currency.
3. If you have a corporation from any state other than Delaware, you may want to consider forming a Delaware General Corporation, authorizing both common and Blank Check Preferred Stock, and then merging your current company into it. This is a little more expensive than starting with it, but it can still be worth it if you have long-term vision.

Here's the best part: The total number of shares of preferred stock that your Certificate of Incorporation authorizes may be split into any number of different series of the preferred stock, and each series can have its own separate terms. For example, let's say the company has 1,000,000 shares of common stock and 100,000 shares of preferred stock. The Board can designate that the preferred stock be split into any number of distinct series, giving you not just one blank check but as many as you desire, all numbered one through whatever number you choose.

At this point, you may be wondering, how do I use these blank checks?

I'm going to enumerate some specific examples of how Delaware Blank Check Preferred Stock has been used to attract investors, maintain or gain control, reward key participants, go public and avoid bankruptcy, as they relate to the rights of each series of preferred stock. However, some general legal knowledge is appropriate first.

Stock ownership comes with certain rights. You can't avoid giving common shareholders the two basic rights previously described. At the same time, you cannot give common shareholders any special rights, like a guaranteed dividend, a guaranteed percentage of the profit or a security interest in the company's assets. Delaware law guarantees them two certain rights but doesn't leave a lot of room for altering or supplementing those rights.

On the other hand, the rights of a preferred stockholder can be negotiated before the stock is issued. These are the three most notable rights that are important in the negotiations:

- **Voting rights:** Common shareholders receive one vote per share, but the Board can give one or more series of the preferred stock super voting power, such as two votes per share, or ten or 100 or 1,000 votes per share, whatever the Board negotiates. Why do this? Let's say the company is trying to attract more capital from a key shareholder who already owns a big percentage of the common stock, but the Board doesn't want him/her to take control of the company. The Board creates a series of preferred stock with no voting rights, but a guaranteed 10% dividend, paid quarterly. This investor might be enticed to invest more money but sacrifice increased voting rights in order to acquire a guaranteed return on his investment. Or, perhaps you are raising capital and you've sold 45% of your stock thus far. Once you sell more than 50% of the company, you lose control. So what do you do? Bring out a series of preferred stock designated as Founder's Stock, in which the 10,000 shares contain 100 votes per share. Instruct the Board of Directors to issue all 10,000 shares to you. Now you can sell more of the common stock to investors while maintaining control of your company. These maneuvers are sophisticated tricks and should be undertaken with the assistance of a really good corporate lawyer.

- **Dividend Rights:** Common stockholders have the right to a share of the profits only if the company has profits and if the Board of Directors declares a dividend. Preferred stockholders, however, can be guaranteed a certain dividend per share ($1.00 per share, for example) or a dividend based on a business calculation that suits the deal (x% of increase in net profits, for example). These dividends can be guaranteed, cumulative and convertible to common stock if the dealmakers agree and a good lawyer drafts it correctly. If properly stated, preferred dividends can be paid before the common stockholders see any return at all.
- **Security Rights:** Preferred stockholders can hold a security interest in a company-owned asset. This can include a patent, a major piece of equipment, the company's website, real estate or any other company asset. In a typical example, if the company is desperate for an influx of cash, bankruptcy is the next step if a deal can't be put together in time to save the company. No one will buy the common stock if they fear the company is going under. However, someone might invest in your company if you give them a security interest in the assets that will revert to them if the company declares bankruptcy. I hope you never

need to use this technique, but if you find yourself in this position, you'll be glad you have a Delaware corporation with Blank Check Preferred Stock.

If you're just about to form your Delaware General Corporation and expect to sell stock in the company to raise money, it would be a good idea to consider acquiring the preferred stock right from the start by including it in the Certificate of Incorporation. This way you won't need the shareholders' approval to authorize it when the time comes that you need it. The Directors will be able to issue the stock in the best interests of the company without the necessity of shareholder approval. If you already run a Delaware General Corporation, you will need shareholder approval to amend the Certificate of Incorporation in order to authorize the preferred shares. If you control the Board and the common stock at the outset, you might be well-advised to consider authorizing a preferred class of stock at your next shareholder meeting so when you need it, it will be there.

Disclaimer:

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