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Preferred Stock and Venture Capital Under the Commercial Companies Code

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A western venture capitalist (particularly American, given that its institutional private equity market comprised about 75% of newly invested funds worldwide in 1999) (the "VC") expects that legal structures will be sufficiently flexible to reflect the business decisions of the VC and the entrepreneur. The Commercial Companies Code of 15 September 2000 ("KSH") has made many positive changes in this regard to a companies code dating to 1934. This article will review some characteristics of preferred stock as used by VCs, and discuss the KSH's approach with respect to a spółka akcyjna ("S.A.", or a joint stock company) and VC structural expectations.

Venture capital defined

Venture capital can be defined as an equity investment (or an investment convertible into equity) in a promising company, or maybe just a promising idea of a capable individual. It is a long-term investment that often requires the VC to wait a number of years before realizing a significant return on the capital resource used. There are wildly successful stories (Intel; Pierre duPont investing in General Motors; Queen Isabella investing in Columbus), spectacular failures (dot.bombs; various railroads of 19th century America). Given that VCs invest in higher risk situations, they expect returns to be commensurately high.

Through venture capital, private equity can be utilized by those with insufficient capital to develop and bring to market innovative goods or services - eventually and hopefully rewarding themselves as well as the VC investing the risk capital, and thus generally promoting economic growth.

Venture capital financial instruments

The typical instruments utilized by a VC are stock (common and preferred), warrants, options, bonds and other convertible debt instruments. The instrument selected determines economic interests and legal rights between the entrepreneur and the VC, typically relating to priority of return, reward for risk, exit strategy, and corporate control. VCs prefer to invest in a senior security that is convertible into, or carries rights to purchase, common stock. If a legal system is not sufficiently flexible in this regard, investment may be hindered or its pricing affected - or perhaps become completely undoable in specific circumstances. If the opportunity is strong enough, the investment will be made, but through an offshore vehicle that can provide sufficient flexibility - leaving the local entity as a wholly owned subsidiary. Of course there are many other determinants for selecting an offshore entity (primarily tax).

Characteristics of preferred stock

Preferred stock is the investment security most frequently used by VCs in capital financing because of its flexibility in tailoring the critical issues of the investment - principally management control, recovery/return and exit. Typically, the preferred stock is convertible into a set number of common shares, at a predetermined price, exercisable at the VC's will (usually at the company's IPO). Thus, preferred shareholders have the upside potential of a liquid equity security traded at significantly appreciated values in the public market. In addition, dividend as well as liquidation preferences are designed to enable the VC to recoup its investment if the enterprise fails to achieve its anticipated success. Preferred shares also commonly have the benefit of compulsory redemption at the option of the VC in agreed circumstances.

Dividends

It is a fundamental legal pre-requisite in most jurisdictions (including Poland) that dividends are only payable if the company has adequate retained profit.

The least sophisticated form of dividend preference is the payment upon a preferred share of a dividend in excess of the amount paid upon a common share. Under the KSH, a preferred share carrying voting rights may receive a preferred dividend not in excess of 150% of the dividend payable with respect to a common share; further, such preferred voting shares cannot have a claim on the company's assets and earnings prior to that of other shares. The 150% limitation seems quite arbitrary, for it is very difficult to find a rationale for such a choice.

A VC requiring a current yield (which is not uncommon) expects the preferred stock to provide a dividend expressed as either a stated annual amount or as a percentage yield based upon the issue price (as opposed to the nominal value) of the preferred share. In Poland, however, stating the return as a percentage yield would not be advisable, as Article 346 of the KSH states that interest may not accrue upon invested capital. Moreover, VCs commonly expect that preferred share dividends will be cumulative (i.e., unpaid dividends aggregate for payment in a later year), and may also expect participation along with the common after receiving the preferred dividend. Neither of these concepts is available under the KSH to voting preferred shares.

Liquidation

What if the investment is a dud?

Preferred stock typically has a preference over the common stock to the assets of the corporation upon liquidation; this is permitted in Poland (Article 351 of the KSH). However, it is common that the VC would like to see the liquidation preference equal the original purchase price of the security plus accrued and unpaid dividends. The VC may also require that the preferred stock have the right to participate parri passu with the common stock in the liquidation distributions of the company after payment of the liquidation preference (so-called "participating" preferred stock).

Voting Rights

Article 351 et seq. of the KSH limit voting preferences: a preferred share cannot carry more than two votes. Moreover, certain personal rights may be vested in a preferred shareholder, such as the right to appoint and recall members of the Supervisory Board or Management Board. Class voting is also contemplated under the KSH with respect to certain matters. Conversely, one can limit the number of votes to which a large shareholder is entitled if that shareholder holds more than 20% of the votes in the S.A. (Article 411 of the KSH).

While one might quibble with the voting preference being limited to two, the KSH is sufficiently elastic (especially given the limitation that can be imposed upon a shareholder holding more than 20% of the votes) to enable a wide range of provisions to be fashioned that will give effect to the business decisions of the VC and the entrepreneur effecting the agreed voting balance.

Conversion Rights

VCs expect conversion rights for their preferred stock: convertible preferred stock may become common shares at the election of the holder at any time prior to redemption and may be automatically converted into common stock upon the occurrence of certain events (e.g., an IPO). The conversion ratio is usually expressed by a formula based upon the original purchase price paid for the preferred stock, which usually (but not always) yields a one-for-one conversion ratio. The conversion ratio is subject to adjustment to take into account:

- stock splits, stock dividends, mergers, consolidations, reclassifications and similar extraordinary corporate transactions;
- accrued and unpaid dividends (these are rare as they are typically forfeited upon conversion); and
- sales of common stock or securities convertible into common stock at prices lower than those paid by the VC (a so-called "dilutive" issue).

To illustrate the "dilutive" issue situation, assume that the subject company is valued at 1,000,000 PLN, with 10,000 outstanding common shares held by the entrepreneur, representing share capital of 500,000 PLN. If the VC ("VC-1") invests for 50% of the company, he would invest 1,000,000 PLN for 10,000 preferred shares convertible into 10,000 common shares. The price to VC-1 would be 100 PLN per share as compared to the entrepreneur's 50 PLN per share, with 100 PLN thus also being the conversion price. Now assume the next round of equity financing is to raise 1,000,000 PLN from a new investor ("VC-2") wishing to receive 20,000 common shares, at 50 PLN per share. A "weighted average" anti-dilution provision would change the initial one-to-one preferred/common conversion ratio to a conversion of the 10,000 preferred shares into 15,000 common shares. The weighted average formula commonly utilized by VCs is

New Conversion Price = (PD + CS) / (D + S)

where:

P = conversion price in effect immediately prior to the new issue or sale (100 PLN in the above example);

D = number of shares of common stock outstanding, or for which issuance or conversion may be made, immediately prior to the new issue or sale, except for the shares issued prior to the issuance of shares to the VC (10,000 above);

C = average consideration per share received by the company for the new issue or sale (50 PLN above); and

S = number of common shares issued or sold, or deemed issued or sold, in the subject transaction (20,000 above).

A "full ratchet" anti-dilution provision would generate 20,000 common shares for VC-1's preferred shares. There are various anti-dilution formulas available but this issue goes far beyond the scope of this paper. Anti-dilution provisions apply not just to a new share issue but also to any issue of instruments that are convertible into common shares, such as convertible bonds.

Such anti-dilution provisions prevent common shares (or instruments convertible into common shares) from being issued at a price lower than the preferred stock conversion price without giving the earlier round preferred shares the benefit of the lower conversion price. VC-1 argues that it has made a riskier investment (i.e., in an earlier round) and its upside potential (as measured by its proportion of common shares that would participate in the upside) should be adjusted proportionately with the investment made by VC-2. The presence of conversion rights creates a link between (i) the value of the convertible preferred stock and (ii) the value of the underlying security into which it is convertible as a proportion of the overall enterprise; the anti-dilution provisions insure that a decrease in the effective issue price of the underlying security does not dilute the value of the preferred stock, considered as a proportion of the total value of the company. Thus, in the example, after conversion following application of the weighted average formula the entrepreneur holds 10,000 common shares, VC-2 20,000 shares and VC-1 15,000 shares. This translates into 50% of a 2,000,000 PLN company for VC-1 prior to the entry of VC-2, and 33 1/3 % of a 3,000,000 PLN company after entry of VC-2, or an interest equal to 1,000,000 PLN in both circumstances; without the application of the weighted average anti-dilution provision VC-1 would have a 25% (valued at 750,000 PLN) interest in a 3,000,000 PLN company after entry of VC-2.

Investors in Poland have some anti-dilution protection in the rights of first refusal under Article 433 of the KSH: a new share issue must be offered proportionately to all shareholders unless foreclosed by an appropriate 80% shareholder vote. However, the problem with the first refusal approach is that it requires VC-1 to invest additional funds in order to maintain its original proportion in the company. In the example, in order to maintain the proportionate interest, VC-1 would have to acquire an additional 3,333 shares of the new 20,000 shares at a cost of 166,500 PLN (an additional investment premium of 16.65% above the initial investment). The necessity of an additional investment in order to maintain the intended proportional interest may reduce the investment that VC-1 is willing to initially make in the company; VC-1 must consider setting aside funds to later protect its proportional position. In VC-1's world, this may not be practical, as VC-1's funds are limited. Setting aside a contingency reduces overall return (as funds must be somewhat liquid) - and may also lower the amount that VC-1 would initially consider paying for a share in the company (i.e., something less than 100 PLN per share for 50% of the company at the end of the first round). Of course, a shareholder with a sufficient number of votes can oppose a share capital increase, but that may not be the best dynamic for the company's development.

Can the concept of convertible preferred shares and the weighted average conversion ratio adjustment work under the KSH? Yes and no.

In Poland preferred stock is entitled to preferences only while it remains registered stock (Article 351 of the KSH); once the shares become bearer shares they lose their preference and become common shares. As, in principle, only bearer shares are qualified for public trading, the KSH requires conversion. Under western venture capital investment concepts as commonly applied, a conversion becomes mandatory only if the public listing of the company occurs pursuant to a firm underwriting with proceeds of an amount sufficient to meet a return threshold as agreed by the VC and the company. The shareholders could adopt a company charter provision that requires either a super-majority or a class vote prior to the company's decision to publicly list. Since this may give effective veto power to a recalcitrant VC, this may not be the entrepreneur's best resolution to the problem at potential IPO-time.

In order to create additional common shares, whichever anti-dilution scheme is used, authorized but unissued shares must be available at the time of conversion. Prior to the effectiveness of the KSH, authorized unissued shares were a foreign concept for a Polish company. The KSH has made some steps in this direction under the concept of target capital (Article 444 of the KSH), but the concepts as implemented are somewhat limiting. The strategy would be that at the time of the preferred share investment the S.A. charter would be amended to authorize a later target capital increase to accommodate a change in the conversion ratios. Inasmuch as the window is three years (but subject to extension) and the maximum that can be offered is 75% of the outstanding share capital upon the date of the adoption of the requisite shareholder authorizing resolution, the present KSH solution is insufficiently flexible. The 75% level is arbitrary - shareholders should be allowed to institute target capital schemes without any such limitations from the beginning.

Redemption

Redemption offers the investor a means of recovering its initial investment. VCs utilize mandatory redemption, at their option, as an exit strategy. The redemption price can be set at the initial investment amount plus dividends that have been agreed at original share issuance but may not have been paid. Ideally, VCs expect redemption provisions to be automatic, subject of course to the company's adequate financial condition.

The KSH has made significant changes to the rules regarding share redemption; previously, shares were redeemable only the consent of the affected shareholder. Under the KSH, the company's articles may provide for share redemption without the consent of the redeeming shareholders if a specified agreed upon event occurs. That appears to grant substantial leeway: for example it could include a demand redemption by the VC in the event that the preferred shares continue outstanding beyond an agreed date. Yet another step, however, is required to finalize the redemption: the Management Board is required by the KSH to adopt an enabling resolution in order to effectuate the redemption. This additional step does not correspond with the VC's needs as the VC expects a clear mechanism that would not be made conditional upon the corporate authorities' decision. If, however, profits are insufficient to redeem the shares in question, a lengthy redemption procedure may be required under Article 456 et seq. of the KSH.

Apparent Limitations

Some of the difficulties mentioned under the KSH can be dealt with easily. The tack would be the issuance of two classes of preferred shares to the VC to solve the voting and dividend limitation problem. As we have already mentioned, the dividend and priority claim restrictions do not apply to non-voting preferred shares (Article 353 § 3 of the KSH). Therefore, a non-voting preferred share can set a preferred dividend higher than the 150%

of the common share dividend and establish priority in payment ahead of other shareholders. Moreover, a non-voting preferred share has the right to cumulate unpaid dividends for later payment for up to three years. While not as freewheeling as the VC might expect, it goes in the right direction. Although no limit appears in the KSH for the dividend payable with respect to a non-voting share, a cautious approach would ensure all that all dividends be commercially supportable.

If non-voting shares are required to implement the preferred return scheme, assigning two votes to each voting share can restore voting balance. Indeed, a melodious symmetry would be an equal number of voting and non-voting shares, the non-voting shares having the necessary economic privileges and the voting shares carrying the corporate powers (of two votes per share). Stated alternatively, the voting and non-voting shares combined have an effective average of one vote per share.

Conclusion

To the extent that there is value in the financial tools that a VC and an entrepreneur can creatively invent, and that we agree that business people should be allowed to make their own decisions, legislation must keep pace with the positive innovations of economic actors. If the law does not support easy implementation of justified business decisions, the law is an obstacle. The KSH appears quite flexible in accommodating many of the common VC techniques with respect to preferred shares, albeit somewhat indirectly at times. Nonetheless, additional amendment is desirable. For example, with respect to preferred stock, the author would (i) remove preferred dividend limitations as well as dividend priority restrictions to avoid the need to establish separate classes of non-voting stock, (ii) eliminate the limitation on target capital amounts, completely implementing the concept of authorized unissued shares, and (iii) enact clear laws where under the company would be legally bound to redeem all shares of a specific class whose redeemable status has been approved (provided that the company's financial condition is appropriate). Additional reform could be brought to bear upon a whole range of corporate and related finance issues, but those topics are outside the narrow scope of this article.

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