Hostage situation

Holders of preferred stock can become the victims of legal blackmail by common stockholders when an early-stage firm fails—unless they take a simple step up front

by Neil J Wertlieb

When an early-stage company stumbles and seems unlikely to recover, outside investors who hold convertible preferred stock usually want the company to sell its assets and liquidate. That way, they can recover at least a few cents on every dollar they have invested. Typically, the preferred holders have first claim on the proceeds from a liquidation; holders of common stock get what's left over.

But in many of these situations, there would be nothing remaining for the common stockholders after the preferred holders are paid off. As a result, the holders of common stock have no incentive to approve a liquidation and, where they control a majority of the voting stock, can effectively prevent it from occurring.

In so doing, the common holders may be engaging in a form of lawful blackmail, holding the preferred shareholders hostage unless they give up some value to the common.

Fortunately, there are some ways to deal with this problem. First, let's look at the motivation of the common shareholders in refusing to vote for liquidation.

At many early-stage companies, much of the common stock is held by the founders. These people often run the company, and because of their salaries, it is rarely in their interest to see the company liquidated. In such situations, it's not unusual for founder-executives to hold on until the bitter end (or at least longer than the preferred holders would like), bleeding the company until it has no more money to pay them.

What about the other holders of common, those who aren't members of management? They may feel that, rather than settling for very little or nothing upon liquidation, they're better off hanging on in hopes that the company will somehow find its way to profitability or at least viability. They may view their shares as options, waiting for the company to recover before they're willing to cash out.

To break this stalemate, preferred stockholders could accede to the common stockholders' potential blackmail threat. One option is to get common shareholders to agree to a liquidation by offering to share a portion of the proceeds with them. Alternatively, the preferred holders could buy out the holders of common stock and then vote their shares in favor of liquidation.

If a company has assets that don't have to be sold as a package, there's another way to deal with the problem posed by reluctant common shareholders: Liquidate in part, putting proceeds from the liquidation into the hands of the preferred holders and leaving behind the remaining assets—e.g., patents or other technology—for holders of the common. This tactic works as long as the remaining assets are attractive enough to the common holders to buy their consent to the partial liquidation.

If all else fails, a last resort—as in most things—would be the threat of litigation, in this case against the common stockholders or the company's directors, or both. The basis for a lawsuit against the directors would be that the board has breached its fiduciary responsibility to the preferred shareholders by failing to act in their best interests.

However, since a liquidation or sale must still be approved by the stockholders, such an action might have a chance of succeeding only if the directors control a majority of the common shares. A suit against the common holders would likely have no legal grounds, because the laws of most states permit those shareholders to vote as they choose.

Why do holders of preferred shares let themselves get into such tight spots? They're usually the lead investors in early-stage companies. In the atmosphere of euphoria and excitement that accompanies investment in a new company, investors rarely consider the possibility of failure in structuring their investment. Because of their liquidation preference, they know that the founders will not be able to get their money out until after the preferred is rewarded. If they believed there was a good likelihood that neither they nor the founders would get paid, they wouldn't make the investment at all. So they don't take any precautions against the type of problem I've described.

All that holders of preferred stock need to do is get common shareholders to agree up front to one of two conditions: that they will give their proxies to the preferred holders in any sale or liquidation supported by the preferred holders or that a majority of them will pre-approve any such transaction.

If the common holders won't accept either of these conditions, it might be wise for investors who are offered preferred stock just to pass on the deal. ■

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