



Avoiding Common Pitfalls in Preferred Stock Transactions

Nov 19, 2014

Reading Time : **2 min**

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Even though a certificate of designations is approved by a company's board of directors without the need for stockholder approval at the time a preferred series is created, any amendments to terms established by that certificate of designations would require the approval of all stockholders entitled to vote unless a company's certificate of incorporation otherwise provides. If a preferred certificate of designations is adopted solely by board approval as permitted by Section 151(a) of the DGCL, it would stand to reason that the board and/or holders of shares of the affected series of preferred stock would be entitled to amend the certificate of designation to adjust the dividend rate or otherwise affect the rights of the preferred stockholders, without any need for other stockholder approvals. However, this is not the case. Under Section 151(g) of the DGCL, once a certificate of designations has been filed with the Delaware secretary of state and become effective, it has the effect of amending the company's certificate of incorporation. Thereafter, if a company desires to amend terms established in the certificate of designations, the company must comply with Section 242 of the DGCL. Section 242, among other things, requires approval of all stockholders entitled to vote on the amendment (in addition to any required class vote) unless no preferred shares have been issued under the certificate of designations. Practically speaking, this requirement typically means approval of the common stockholders and the preferred stockholders, each voting separately, is required to amend terms established in the preferred certificate of designations. Oftentimes, a company desires the right to amend a preferred certificate of designations solely with the vote of holders of the preferred series. Companies that desire this flexibility cannot simply insert a provision in the certificate of designations for a new preferred series that denies consent rights to other series of capital stock on amendments affecting only the terms of the new series. Rather, in addition to inclusion of such a

“preferred only” consent right provision in the certificate of designations, the certificate of incorporation itself must already contain a provision to such effect (i.e., that common stockholders will not be entitled to vote on any amendment to a certificate of designations if the holders of such affected series are entitled to vote on the amendment), or the certificate of incorporation must be amended, with approval of the common stockholders, to so provide.

The above limitations and requirements should be kept in mind when drafting an initial certificate of incorporation for a company where the possibility of a future preferred issuance exists, as well as when creating or amending a new series of preferred stock. Such restrictions determine what rights may be granted to the preferred holders under the certificate of designations without seeking further approvals or what approvals are required in connection with an amendment to the certificate of designations, as the case may be.

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