

## MEMO TO THE PARTNER

### REDEMPTION PROVISIONS FOR SERIES A PREFERRED STOCK

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TO: Law Office Partner  
FROM: Associate  
RE: Redemption Rights for Certificate of Designations for Preferred Stock

#### INTRODUCTION

You asked me to draft redemption provisions for the Certificate of Designations for a series of preferred stock to be issued by our client, Client, Ltd., a Delaware corporation, (“Issuer”), to Investor, Inc., a Delaware corporation (“Investor”). Attached for your review is Rider A, containing the requested draft redemption provisions as well as a list of relevant defined terms. The provisions in Rider A labeled “Redemption” and “Defined Terms” should be inserted into their respective positions in the Certificate of Designations of Issuer, subject to your review.

In this memorandum, I detail the transactional context in which Issuer will issue preferred stock to Investor; identify the key issues presented within this transactional context; and explain the rationale for most major and minor drafting choices. Unless otherwise indicated, any defined terms in this memorandum have the same meaning given them in the Certificate of Designations attached as Rider A; any other defined terms not included in the attached Certificate of Designations have the meaning given them in the previously drafted portions of the Certificate of Designations.

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<sup>1</sup> Allison L. Bussell graduated from the University of Tennessee College of Law in May 2004. She is a graduate of Middle Tennessee State University. In 2004-2005, Mrs. Bussell will clerk for Joseph M. Hood in the United States District Court for the Eastern District of Kentucky. Mrs. Bussell would like to thank Professor Joan MacLeod Heminway for her insights on earlier drafts of this work.

### TRANSACTIONAL CONTEXT

Issuer creates, markets, and manufactures sports-based computer and video game systems and software. Issuer is seeking investor funding to begin a new software development project. The new software, entitled VirtualPlayer, is a sports (baseball, football, soccer, and basketball) video game plug-in that enables users to download professional team and player statistics from the Internet for use with the user's corresponding computer or video game console. VirtualPlayer allows users to update player rosters, injury reports, and sports franchises without purchasing new software.

Investor is a well respected holding company that traditionally invests in successful computer software companies listed on the New York Stock Exchange ("NYSE"). Investor views this transaction as a perfect opportunity to diversify by investing in a video game system and software company. Investor views the VirtualPlayer project as an innovative venture with a minimal risk exposure. Issuer and Investor have already negotiated many of the provisions to be included in the Certificate of Designations. However, Investor and Issuer have not yet agreed upon the terms of the redemption provisions. Investor has requested that we draft a Certificate of Designations containing currently agreed upon terms and the redemption provisions.

Issuer desires an unlimited redemption option on all shares of preferred stock issued to Investor. On the other hand, Issuer recognizes that a redemption option is rarely attractive to investors who want to assure long-term dividend payments. Accordingly, the terms of the redemption provisions must be attractive enough to induce Investor to approve the proposed Certificate of Designations, while at the same time satisfying Issuer's desire to maximize its redemption options.

Issuer's Certificate of Incorporation authorizes its Board of Directors to issue 100,000,000 shares of stock – 90,000,000 common and 10,000,000 preferred. In accordance with Delaware General Corporation Law ("DGCL") §151(a), the Certificate of Incorporation contains a "blank check" provision giving the Issuer's Board of Directors complete discretion to issue preferred stock in one or more series and to fix, by resolution, the designation, powers, preferences, and rights of any series of preferred stock. As stated in the Issuer's Certificate of Incorporation, this "blank check" authority includes the right to determine "whether or not the shares of such series shall be subject to redemption by the Corporation and the times, prices, and other terms and conditions of such redemption." To date, Issuer has

55,000,000 shares of common stock and no preferred stock outstanding. Issuer's sole class of stock is publicly traded on the NYSE, with an average trading price over the last twelve months of \$55.00 per share.

As the negotiations currently stand, Investor will invest \$3,500,000 to finance Issuer's VirtualPlayer project. In exchange, in accordance with DGCL § 161, Issuer will issue 70,000 shares of Series A Convertible Redeemable Preferred Stock, par value of \$0.01 per share and a Stated Value of \$50.00 per share ("Series A Preferred Stock") to Investor. Both Issuer and Investor expect these new preferred shares to be publicly traded in the near future. Accordingly, Investor has requested that the redemption provisions satisfy the NYSE listing requirements for preferred stock.

#### ISSUES PRESENTED

- (1) Does Issuer's Board of Directors have the authority to include redemption provisions in the Certificate of Designations for the upcoming issuance of preferred stock?**

We must look to two sources to determine whether Issuer may include redemption provisions in the Certificate of Designations: (1) the DGCL, and (2) the Issuer Certificate of Incorporation. Both sources must authorize such redemption provisions to effectuate the proposed issuance.

- (2) Of the various types of redemption rights, which will best serve the goals and address the concerns of both Issuer and Investor?**

The redemption provisions included in the Certificate of Designations must serve the goals of both Issuer and Investor to induce effectuation of the transaction. Issuer and Investor have some similar and some conflicting goals and concerns regarding the forthcoming issuance. Issuer needs quick financing to exploit the current market opportunity. However, Issuer also wants the right to redeem its preferred shares at some point in the future to prevent an indefinite priority to dividends for its preferred stock holders. On the other hand, Investor wants to maintain that priority right long enough to compensate it for the investment risk. Additionally, Investor hopes the project's success will cause an appreciation in the preferred stock's fair market value which it can take advantage of without the possibility of a less than market value redemption by the Issuer.

**(3) Does the timeline of the proposed redemption right address the goals and concerns of both Issuer and Investor?**

Time is of the essence in this transaction. Issuer does not want to extend dividend priority to its preferred shareholders indefinitely. On the other hand, Investor hopes to maintain control of the preferred stock in the likely event that the preferred stock's market value increases with the success of VirtualPlayer. Accordingly, the initial redemption date of the shares of Series A Preferred Stock will directly impact Investor's decision to invest.

**(4) How do the proposed redemption provisions satisfy Issuer's and Investor's future trading goals of the Series A Preferred shares?**

Both parties foresee the possibility of the preferred stock being traded on a public market. To facilitate this possibility, the proposed redemption provisions must satisfy the NYSE listing requirements for preferred stock. This will prevent future costly and timely compliance amendments to the preferred stock.

**ANALYSIS OF DRAFTING CHOICES*****Major Drafting Decisions*****Authority for Inclusion of Redemption Provisions**

DGCL § 151(a) grants Issuer the authority to “issue 1 or more series of stock within any class thereof . . . hav[ing] . . . such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation.” DGCL § 160(a)(1) gives Issuer the authority to “redeem its own shares” of stock if the redemption does not impair Issuer's capital or cause Issuer's capital to be impaired. The statute further states that an issuer must redeem its shares in accordance with its Certificate of Incorporation and the resolution or resolutions providing for the issuance of such shares of stock. DGCL § 160(a)(3).

As discussed above, Issuer's Certificate of Incorporation contains a “blank check” provision giving the Issuer's Board of Directors complete discretion to issue preferred stock in one or more series, and to fix, by resolution, the designation, powers, preferences, and relative participating, optional or other special rights of any series of preferred stock. Specifically, this “blank check” provision authorizes the

Issuer's Board of Directors to determine whether any shares it issues "shall be subject to redemption . . . and the times, prices, and other terms and conditions of such redemption." Accordingly, the Certificate of Designations for the issuance of shares of Series A Preferred Stock to Investor will include a sufficient representation of the redemption terms and provisions to meet these requirements.

### **Type of Redemption Provisions**

I believe that an optional redemption would best serve the interests of both Investor and Issuer. Although a mandatory redemption provision would serve Issuer's interest in limiting the priority of dividend payments in the future, Investor will almost certainly object to a mandatory redemption provision. Mandatory redemption forces the redemption of the shares of Series A Preferred Stock on a certain date or upon the happening of a specified event regardless of whether the parties wanted to maintain their business relationship. Further, mandatory redemption provisions are traditionally used to mitigate an unsuccessful venturer's losses; an ominous tool to include in a transaction in which both parties expect success.

A redemption option, on the other hand, better serves the interest of both parties. An optional right to redeem gives the Issuer the option to either continue paying priority dividends to the holder of the preferred stock, or redeem the stock using a predetermined formula. This prevents the Issuer from having to continue paying priority dividends on its preferred stock if redemption would be more cost effective. The Investor, however, fears that the Issuer will redeem the preferred stock at a time when its market price is greater than the Redemption Price. Accordingly, the Investor is unlikely to agree to a redemption option absent some other protection that compensates the Investor for its investment risk.

To off-set this risk to the Investor, the Redemption Price shall be 120% of the Stated Value. Even at a time when Issuer's preferred stock is successful on the market, Investor will receive, upon redemption, 20% more for the preferred shares than it originally paid. Furthermore, if the VirtualPlayer project is unsuccessful, the right of redemption will provide Investor with the option to liquidate shares at a greater than market value Redemption Price.

To further protect Investor's interests, conversion rights are included in the Certificate of Designations. Specifically, included in the redemption provisions is the right of a holder to convert its shares of Series A Preferred Stock into common stock

(pursuant to the conversion provisions that have already been drafted) – even after Issuer has issued the Notice of Redemption. These redemption provisions further protect Investor by prohibiting Issuer from redeeming any shares of Series A Preferred Stock when the Holder of the shares gives a Notice of Conversion.

### **Timeline for Redemption**

The right of redemption shall not become operable until four years from the date of issuance. Because it will take Issuer several years to develop the infrastructure to develop, produce, and market VirtualPlayer, the project will most likely not become profitable for at least two-and-a-half years. The four-year waiting period will allow enough time to determine the success of the product. Additionally, the four-year waiting period fulfills Investor's need to receive dividends for a longer, more defined period of time. Further, even though Issuer's common stockholders do not have priority regarding payment of dividends, Investor will have the ability to maintain its ownership in Issuer if Investor elects to convert its Series A Preferred Stock upon receipt of a Notice of Redemption from Issuer.

### **Requirements for Trading the Shares Publicly**

Included in the redemption provisions are all of the NYSE's listing requirements for shares subject to redemption. First, the NYSE requires that Notice of Redemption be given to the Holder not less than 30 days, but not more than 90 days, before the Redemption Date. The proposed redemption provisions satisfy this requirement by requiring the Corporation to deliver the Notice of Redemption to the Holder not less than 30 days and not more than 90 days before the Redemption Date. I further specified in the redemption provisions that Notice of Redemption is effective only upon receipt by the Holder to ensure that the redemption provisions satisfy the NYSE listing requirement.

The second NYSE listing requirement states that, for shares that are subject to redemption and conversion, a corporation must provide Holders with the option of exercising their right of conversion after the corporation publishes the Notice of Redemption. I satisfied this requirement by giving Holders 10 days following receipt of the Notice of Redemption to convert their shares in accordance with the conversion provisions of the Certificate of Designations.

Finally, in accordance with the NYSE's listing requirements for preferred shares, I specified in the redemption provisions that if Issuer chooses to redeem

fewer than all of the outstanding shares of Series A Preferred Stock, the Issuer's Board of Directors shall determine which shares to redeem on a Pro Rata basis.

***Minor Drafting Choices***

Because the redemption provisions were relatively short in length, I chose not to use subheadings within the provisions. However, I divided the redemption provisions into five paragraphs to make the provisions easier to read. The "Defined Terms" provision is in the first section of the complete Certificate of Designations. The "Defined Terms" are only those relevant to the draft redemption provisions and likely have not been defined in other portions of the Certificate of Designations.<sup>2</sup> The empty brackets in Rider A represent what will be the Section number for the redemption provisions. The empty parentheses in the Defined Terms provision indicate where the subsection numbers for the various Defined Terms should be inserted after they are ordered alphabetically within Section 1 of the complete Certificate of Designations.

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<sup>2</sup> For example, terms such as Board of Directors, Business Day, Holder, Issue Date, and Notice of Conversion are used in other provisions within the Certificate of Designations and already have been drafted and defined. I have included definitions for any terms that have not already been defined.

**Rider A**

**CERTIFICATE OF DESIGNATIONS OF  
SERIES A CONVERTIBLE REDEEMABLE PREFERRED STOCK  
OF CLIENT, LTD.**

*Section 1.      Defined Terms.*

The terms defined in this Section 1 shall have, for all purposes of this Certificate of Designations, the meanings herein specified (with terms defined in the singular having comparable meanings when used in the plural).

( )      “Notice of Redemption” is defined in Section [ ](b).

( )      “Optional Redemption” is defined in Section [ ](b).

( )      “Pro Rata” is defined in Section [ ](d).

( )      “Redemption Date” means the date stated in the Notice of Redemption as the date on which Optional Redemption will occur.

( )      “Redemption Agent” means the person or entity appointed by the Corporation to hold funds in trust, deposited by the Corporation to pay to the Holders of shares of Series A Preferred Stock to be redeemed. Any Redemption Agent shall be a national banking association or corporation organized and doing business under the laws of the United States of America or of any state or territory thereof or of the District of Columbia.

( )      “Redemption Price” is defined in Section [ ](b).

( )      “Stated Value” means \$50.00 per share of Series A Preferred Stock.

*Section [ ].      Redemption at the Option of the Corporation.*

(a)      Shares of Series A Preferred Stock shall not be redeemable prior to the fourth anniversary of the Issue Date.

(b)      On or after the fourth anniversary of the Issue Date, the Corporation, at its option, may redeem any or all shares of Series



A Preferred Stock then outstanding from the Holders thereof (“Optional Redemption”) by paying to the Holder a cash amount equaling 120% of the Stated Value plus all accrued and unpaid dividends thereon to the date fixed for redemption (“Redemption Price”). At least 30 days but not more than 90 days prior to the Redemption Date, the Corporation shall give written notice to the Holder, by delivery in person or by certified or registered mail, that the shares of Series A Preferred Stock will be redeemed (“Notice of Redemption”). Notice of Redemption is effective only upon receipt by the Holder. The Notice of Redemption shall include the following information: (i) the Redemption Date, (ii) the Redemption Price, (iii) the total number of shares of Series A Preferred Stock to be redeemed by the Corporation, (iv) the names of the place or places at which the shares of Series A Preferred Stock will be surrendered for redemption, and (v) the name of the Redemption Agent.

- (c) A Notice of Redemption is effective only if received by a Holder who has not given the Corporation a Notice of Conversion at any time before receipt of such Notice of Redemption. The Holder of shares of Series A Preferred Stock may elect within 10 Business Days after receipt of a Notice of Redemption to give the Corporation a Notice of Conversion in connection with some or all of the shares subject to redemption.
- (d) If the Corporation elects to redeem fewer than all of the outstanding shares of Series A Preferred Stock, the shares to be redeemed from each Holder shall be determined by the Board of Directors on a Pro Rata basis based on the number of shares of the Series A Preferred Stock held by the Holders, with any fractional shares being rounded up to the nearest whole share.
- (e) The Redemption Price must be paid out of legally available funds to the Holder no later than the seventh Business Day after the Redemption Date. In the event that the Corporation fails to pay to the Holder the Redemption Price on or before the seventh Business Day after the Redemption Date, the Redemption Notice will be null and void, and the Holder will regain full possession and ownership of the shares previously redeemed or surrendered.