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Companies Implementing 'Super-Voting Preferred Stock' as Stockholder Meeting Solution

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Increasingly, many small-cap and microcap public companies are failing to secure stockholder approval of critical proposals, particularly for reverse stock splits and authorized share increases. With heavy concentration of shares held in street name (i.e., by retail investors in US brokerage accounts), these companies historically have relied on brokerage firms to vote retail shares both to establish a quorum – the minimum threshold in voting power of shares that must be present to validly convene a stockholder meeting – and to pass what are known as "routine" proposals (proposals on which brokers have discretionary authority to vote shares held in street name when they have not received instructions from the beneficial owner).

Recently, several large brokerage firms have eliminated discretionary voting, which has had the effect of significantly decreasing the number of shares represented at stockholder meetings. As a result, companies with substantial retail concentration are finding it difficult to establish a quorum, leading to increased stockholder solicitation costs, multiple meeting adjournments and/or failed "routine" proposals – including proposals that, while "routine" under stock exchange rules, are consequential, such as charter amendments to implement reverse stock splits designed to assist in regaining or maintaining compliance with stock exchange minimum price requirements and authorized share increases intended to enable companies to opportunistically pursue equity financing.

As retail holders generally do not have substantial holdings in any given company, they are viewed as displaying "rational apathy" when it comes to voting – that is, their level of economic interest does not warrant the time and effort that would be required to review proxy materials and cast an informed vote. Without broker discretionary voting, these "routine" proposals, despite being approved by the holders of a majority of the shares actually voted at the meeting, frequently fail due to the higher voting threshold (typically a majority of the voting power of the outstanding shares) required to pass the proposal.

Affected companies have sought creative solutions, including unilaterally amending their bylaws to decrease the number of shares required to achieve quorum, as the laws of Delaware and many other states permit quorum to be reduced to one-third of the voting power of the outstanding stock, and shifting from a "majority of the votes present in person or by proxy" standard to a lower "majority of the votes cast" standard for all matters other than those on which the charter or applicable law requires a different or greater vote. But reducing quorum or the default voting standard does not solve the greater hurdle of securing the requisite vote of stockholders to approve critical proposals subject to heightened voting requirements. As a result, many companies, particularly those listed on Nasdaq, have begun implementing "super-voting preferred stock" as a means of magnifying the vote of stockholders who remain active and engaged, and thereby bolster the prospect of achieving heightened voting standards.

What is 'super-voting preferred stock'?

In this context, "super-voting preferred stock" refers to a series of preferred stock, designated through a resolution of the board of directors using the "blank check" authority provided by the charter, that carries with it a disproportionately large number of votes per share (e.g., 250,000,000 votes per share of preferred) in comparison to the existing outstanding classes or series of a company's stock. The super-voting preferred stock is issued in advance of the record date for determining stockholders entitled to vote at a meeting, and it is designed to give its holder the power to vote for certain "routine" proposals that would likely otherwise fail due to

low participation among stockholders – typically retail investors.

While there are numerous variations, in cases where the company issues shares of super-voting preferred stock to one or more new investors, the super-voting preferred stock typically will be designated with the following rights, powers and preferences (and corresponding restrictions and limitations):

- The power to vote together with the common stock (or other outstanding classes or series of voting stock) as a single class on the proposal(s) for which it was designated. The super-voting preferred stock will be voted in the same proportion as the votes cast by the shares of common stock (or other outstanding classes or series of voting stock) on such proposal, with no other voting rights except for those required by the applicable state law.
- Either restrictions on the right to convert into shares of any other class or series of stock of the company, or on the right to convert into common stock only after stockholder approval of the proposal(s) for which the super-voting preferred stock was adopted.
- A 1x liquidation preference and no dividend entitlement.
- An automatic redemption by the company immediately following the approval of the proposal(s) for which it was adopted (or optional redemption, if the super-voting preferred stock is convertible into common stock).

Regulatory landscape

Stock exchange requirements

Super-voting preferred stock is generally prohibited under stock exchange rules. Nasdaq Listing Rule 5640 and Section 313 of the NYSE Listed Company Manual prohibit corporate actions that would disparately reduce or restrict existing stockholder rights, including through the issuance of super-voting preferred stock. However, a company seeking to implement super-voting preferred stock in the stockholder meeting context may be able to do so under the circumstances described below in consultation with the applicable exchange.

In contrast to Nasdaq and New York Stock Exchange requirements for US companies, both exchanges will accept an action or issuance by a non-US company relating to its voting rights structure that is not prohibited by the company's home country law.

Formal guidance from Nasdaq and the NYSE on super-voting preferred stock is unavailable. However, through consultation with Nasdaq and Nasdaq consultants and a review of recent filings by Nasdaq-listed companies, we've determined that three criteria are necessary for Nasdaq compliance, as outlined below.

1. Separate quorum

For the proposals on which the super-voting preferred stock will vote, the company must achieve quorum without relying on the super-voting preferred stock. Typically, the quorum requirement is specified in the company's bylaws and requires the presence in person or by proxy of a majority of the voting power of the outstanding shares of stock entitled to vote, except where otherwise provided by statute or the company's certificate of incorporation.

> **Sidebar:** In response to the increasing challenge of achieving quorum for stockholder meetings, many companies have unilaterally reduced their quorum threshold where the quorum requirement is specified solely in their bylaws (and thus not requiring a charter amendment and separate stockholder approval). As noted above, for Delaware corporations, a quorum can be reduced to not less than one-third of the votes represented by shares outstanding on

the record date for the stockholder meeting. Reducing the quorum requirement is not without risk and should involve a careful assessment of the specific company's unique circumstances, including stockholder activism and takeover risks.

2. Mirror voting

The super-voting preferred stock must be voted in the same proportion as the votes cast by the shares of common stock on the proposal(s) for which the super-voting preferred stock is entitled to vote. This often requires issuing a super-voting preferred stock with what may seem like an inordinately high number of votes.

For example, assume a company has 10,000,000 outstanding shares of common stock, each entitled to one vote per share, and, prior to its stockholder meeting, issues one share of super-voting preferred stock having 400,000,000 votes, with the super-voting preferred stock being entitled to vote only on a reverse stock split proposal. The company's quorum requirement has been reduced to one-third of the voting power of the voting stock, but the company still needs the proposal to be approved by the holders of a majority of the voting power of the outstanding shares of all stock. Assuming only the minimum one-third of the voting power of the common stock is represented at the meeting (satisfying the separate quorum requirement), and 51% of such shares of common stock are voted in favor of the proposal, the super-voting preferred stock would cast 204,000,000 votes in favor of the proposal, resulting in an aggregate of 205,700,001 total votes in favor of the proposal, just slightly more than the 205,000,001 votes needed to pass the proposal.

3. Limited purpose

The super-voting preferred stock must only have voting rights on the proposal(s) for which it is designated. Upon passing of the proposal(s), the super-voting preferred stock will have no voting rights, except for those required by the applicable state law, and consequently typically will be redeemed (sometimes automatically) or converted into regular common stock.

In addition, the only two proposals for which Nasdaq has pre-blessed the use of super-voting preferred stock are an authorized shares increase and a reverse stock split, assuming in each case that such proposal is not related to another proposal (e.g., a reverse stock split in connection with a reverse merger transaction). It is possible that Nasdaq would permit the use of super-voting preferred stock to pass other proposals where the need to solicit stockholder approval stems solely from state law, but those would need to be discussed with Nasdaq on a case-by-case basis. Nasdaq has confirmed, however, that in no instance can super-voting preferred stock be used to secure approval of a proposal that requires stockholder approval under Nasdaq rules (e.g., a transaction that requires stockholder approval under Nasdaq Listing Rule 5635, such as a "change of control" and certain equity issuances).

State corporate law

In addition to stock exchange compliance considerations, companies should carefully structure the super-voting preferred stock to ensure compliance with their respective organizational documents and the requirements of state corporate law. We've summarized key considerations for Delaware corporations below.

The super-voting preferred stock must have a preference over the common stock in order to be considered "preferred stock." A nominal liquidation preference equal to the purchase price of the super-voting preferred stock (which itself may be nominal) is one approach.

The holder of the super-voting preferred stock should be subject to a voting agreement (either in the purchase/issuance

agreement or in a stand-alone voting agreement), as automatic voting is of questionable validity.

The applicable voting standard should be evaluated to ensure the super-voting preferred stock can be utilized. While the voting standard for charter amendments is typically a majority of the voting power of the outstanding shares, some companies may have adopted charter provisions imposing greater or additional votes. For example, the charter may require approval by the holders of a majority of the outstanding stock entitled to vote generally in the election of directors. In that instance, the company would need to coordinate with the stock exchange to ensure the super-voting preferred stock could be granted the nominal right to vote in the election of directors – otherwise, the super-voting preferred stock would be unable to vote on the key charter amendment proposals – without violating the exchange's listing rules (e.g., by employing design protections that ensure the super-voting preferred stock cannot actually influence the election of directors). Likewise, affected companies would need to assess whether such nominal right to vote in the election of directors may inadvertently trip a "change of control" clause under any outstanding equity plan awards, warrants, debt covenants or other agreements.

Careful attention must be given to the class voting requirements. In Delaware, for instance, certain charter amendments require separate class votes, whether or not the holders of such class would otherwise be entitled to vote thereon. Pursuant to Section 242(b) of the Delaware General Corporation Law, a class of stock is entitled to vote as a class on any increase or decrease to the authorized number of shares of the class unless the charter itself contains a so-called 242(b)(2) carve out expressly providing that the number of shares of the class may be increased or decreased (but not below the number of outstanding shares of the class) by the holders of a majority of the stock entitled to vote, irrespective of Section 242(b)(2). Unless the charter of a Delaware corporation includes such a carve out, the super-voting preferred stock may not be used to increase the number of authorized shares of common stock. While the charters of many venture capital-backed private companies include such provisions, such carve outs do not uniformly appear in public company charters. Accordingly, any company seeking to use super-voting preferred stock to approve an increase in the authorized common stock will need to confirm that their charter contains a provision that enables the super-voting preferred stock to be included in the vote on the proposal.

The number of votes given to the super-voting preferred stock will be part of the denominator for determining whether a reverse stock split amendment or other charter amendment that does not require a separate common stock class vote has achieved the requisite approval of a majority of the outstanding voting stock. Accordingly, companies seeking to adopt super-voting preferred stock should first run an exact calculation of the number of votes needed to approve the proposal, factoring in the additional vote count from the super-voting preferred stock.

Sidebar: Recently, Senate Bill No. 114 was introduced in the General Assembly of the Delaware State Senate to amend Title 8 of the General Corporation Law of the State of Delaware. If this legislation is enacted (anticipated as early as August 1, 2023), the threshold to approve a reverse stock split will be reduced from a majority of the voting power of the outstanding shares to a majority of the votes cast at the stockholder meeting. Similarly, the threshold to approve an increase (or decrease) in the authorized number of shares of a class of stock would be reduced to a majority of the votes cast by the affected class of stock. These amended voting thresholds would apply only to Delaware corporations with securities listed on a national securities exchange, and they would not supersede any higher voting threshold that may be specified in the company's charter.

Proxy adviser considerations

In its 2022 proxy season review, ISS identified the use of super-voting preferred stock as an emerging trend in connection with passing certain critical agenda items, but also noted that it is unclear whether super-voting preferred stock will be narrowly used in

this way in the future.

ISS and Glass Lewis take a similar negative view of companies with unequal voting rights and multiclass structures, framing them as typically not in the best interests of the common stockholders; ISS generally recommends withhold votes or voting against directors individually, committee members or the entire board, while Glass Lewis generally recommends voting against the chair of the governance committee when a company employs a capital structure with unequal voting rights.

However, by narrowly tailoring the super-voting preferred stock so that it has limited application solely to the critical proposals for which a majority of the voting power of the outstanding shares is required, and otherwise establishing its terms in a manner that does not harm the common stockholders (e.g., no significant liquidation preference, no favorable redemption rights, no favorable conversion rights, no dividend right and no additional voting rights), the use of super-voting preferred stock should generally not result in a negative reaction from these proxy advisory firms.

Implementing super-voting preferred stock

To date, companies have primarily implemented super-voting preferred stock either through a direct issuance to a select individual or significant stockholder(s) **or** a dividend to common stockholders. In each instance, the stock is solely entitled to vote on specific proposals for an upcoming stockholder meeting.

New issuance

A company designates the class/series of super-voting preferred stock prior to the record date for the stockholder meeting, then issues the super-voting preferred stock to a select individual (e.g., CEO or board chair) or one or more significant stockholders. To ensure mirror voting, in addition to a voting requirement included in the certificate of designation, the company also enters into a voting agreement with the purchaser of the super-voting preferred stock.

Dividend approach

A company declares a dividend of the newly designated super-voting preferred stock on the outstanding common stock prior to the record date for determining stockholders entitled to vote on one or more proposals. In this context, the super-voting preferred stock has certain additional and/or distinct features relative to the “new issuance approach,” in light of the added complexity introduced by a dividend.

- The certificate of designation for the super-voting preferred stock issued under this approach typically provides that:
  - Any shares of super-voting preferred stock that are not represented at the stockholder meeting (as of immediately prior to the polls opening for the meeting) for which the super-voting preferred stock was adopted are automatically redeemed by the company at such time.
  - The outstanding shares of super-voting preferred stock not so redeemed are separately redeemed following the approval of the proposal(s) for which the super-voting preferred stock was adopted.
- The super-voting preferred stock is transferable only if transferred together with the underlying common stock on which it was issued as a dividend.

In this instance, the super-voting preferred stock operates to magnify the vote of the stockholders who participate in the vote. The structure is premised on a principle of Delaware law that shares reacquired by the company after the record date for determining stockholders entitled to vote at the meeting but before the vote is taken at the meeting are not counted for quorum or voting purposes. Thus, the shares of super-voting preferred stock that are redeemed prior to the opening of the polls at the meeting cease

to count for purposes of determining whether a quorum is present and are not included in the denominator for determining the requisite vote. By contrast, the shares of super-voting preferred stock held by stockholders who are present or represented by proxy at the meeting remain outstanding for quorum or voting purposes. This structure attempts to provide a direct means of combating the “rational apathy” problem among retail holders that so many microcap and small-cap companies face. It does not serve to manufacture the outcome of any vote; rather, it amplifies the voices of the active and engaged stockholders.

Observations and commentary

Super-voting preferred stock can be an effective mechanism to secure stockholder approval of certain critical proposals for companies with significant retail stockholder bases and a decline in broker discretionary voting, primarily for proposals that require a majority of the voting power of the outstanding shares for approval (e.g., reverse stock splits to regain stock exchange compliance and increases in authorized shares to enable future opportunistic equity financings) in cases where the active and engaged stockholders are supportive of the proposals. As with any action taken by or on behalf of the company’s board of directors, the validity of super-voting preferred stock will be “twice tested”: once for compliance with technical provisions of corporate law and again in equity. In addition to the factors outlined above, companies considering the deployment of super-voting preferred stock should consider all equitable factors, assessing, among other things, the factors that may be contributing to the failure of any vote on a proposal as well as the potential consequences of the failure to secure approval.

Companies seeking to implement super-voting preferred stock should carefully plan the process, bearing in mind:

- Coordinating with the applicable stock exchange is key. Although some consistency in practice has developed for Nasdaq-listed companies, a company should carefully consider the structure it intends to adopt and coordinate with the applicable stock exchange to ensure the proposed approach does not violate the applicable stock exchange’s rules.
- Provisions of state corporation law and the company’s organizational documents are equally important, including whether the company’s charter would permit the preferred stock to vote with the common stock on an authorized share increase.
- Super-voting preferred stock does not solve for the separate need to achieve a quorum of the common stock.

As super-voting preferred stock increases in prevalence, additional guidance from stock exchanges and proxy advisory firms may emerge that could impact the considerations covered in this alert. In addition, if the Delaware legislation referenced above is enacted, the super-voting preferred stock discussed in this alert may not be relevant or necessary for publicly listed Delaware corporations. However, for the time being, super-voting preferred stock, where deployed in good faith and in an equitable manner, can be a viable solution for companies impacted by the lack of broker discretionary voting at their stockholder meetings.

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