Rules and Rights of Common and Preferred Stock

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WHAT'S COVERED

In this lesson, you will learn how to compare the ownership of common and preferred stock. Specifically, this lesson will cover:

1. Claim to Income

Preferred and common stock have varying claims to income which will change from one equity issuer to another. In general, preferred stock will be given some preference in assets to common assets in the case of company liquidation, but both will fall behind bondholders when asset distribution takes place.

In the event of bankruptcy, common stock investors receive any remaining funds after bondholders, creditors (including employees), and preferred stockholders are paid. As such, these investors often receive nothing after a bankruptcy.

Preferred stock also has the first right to receive dividends. In general, common stock shareholders will not receive dividends until they are paid out to preferred shareholders. Access to dividends and other rights vary from firm to firm.

In the event of a company's liquidation, preferred stock may or may not have a fixed liquidation value, or par value, assigned to it. This face value comprises the amount of capital contributed to the company at the time of the shares' issuance. Upon a corporation's liquidation, preferred stock can claim proceeds equal to its par (or liquidation) value, except if this was negotiated in a different manner. This claim takes precedence over the claim of common stock, which only has a residual claim.

Both types of stock can have a claim to income in the form of capital appreciation as well. As company value increases based on market determinants, the value of equity held in this company also will increase. This translates to a return on investment to shareholders. This will be different for common stock shareholders and preferred stock shareholders because of the different prices and rewards based on holding these different kinds of shares. In turn, should market forces decrease, the value of equity held will decrease as well, reflecting a loss on investment and, therefore, a decrease in the value of any claims to income for shareholders.

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2. Voting Rights

Common stock can also be referred to as a “voting share.” Common stock usually carries with it**voting rights** on business entity matters, such as electing the board of directors, establishing corporate objectives and policy, and stock splits. However, common stock can be broken into voting and non-voting classes. While having superior rights to dividends and assets over common stock, generally preferred stock does not carry voting rights.

The matters that a stockholder gets to vote on vary from company to company. In many cases, the shareholder will be able to vote for members of a company board of directors and, in general, each share gets a vote as opposed to each shareholder.

> ↪ EXAMPLE A single investor who owns 300 shares will have more say in a voting matter than a single shareholder that owns 30.

Every year, official bodies and associations involving the general public, such as companies with shareholders, hold a mandatory meeting known as an annual general meeting, or AGM. These meetings, which are often required by law, are held annually to elect the board of directors and update their members of all activities, past and future.

An AGM also provides a forum for a shareholder to exercise many of his or her voting rights, as well as an opportunity for shareholders and partners to review copies of the company’s accounts and fiscal information for the previous year, and to get answers to any questions they may have regarding the future trajectory of the business. If shareholders are unable to attend the AGM, they can opt to mail in their votes. To this end, in 2007, the Securities and Exchange Commission voted to mandate all public companies to provide access to their annual meeting materials online, so that shareholders would have multiple ways to exercise their voting rights if they were so inclined.

TERM TO KNOW

Voting Rights

Rights that are generally associated with common stock shareholders in regards to business entity matters (such as electing the board of directors or establishing corporate policy).

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3. Purchasing New Shares

New share purchases are an important action by shareholders, since it requires a further investment in a business entity and is a reflection of a shareholder’s decision to maintain an ownership position in a company or a potential investor's belief that purchasing equity in a company will be an investment that grows in value.

In the case of new stock issuances by a company, current shareholders may have the right of**preemption**, the most common form in practice being the right to obtain new shares issued by a company in a rights issue, which is typically - but not always - a public offering. In this circumstance, the preemptive right is also known as “subscription right” or “subscription privilege,” which is a right, but not a requirement, of current shareholders to purchase the new shares before they are offered to the public. In this manner, current shareholders are able to preserve their proportional ownership of the company, while preventing dilution of the stock.

If shareholders decide to purchase the new stock, the transaction is performed over the same exchange mechanism as the purchase of the previous stock, known as a **stock exchange**. This form of exchange is often the most important element of a stock market, and it provides services whereby traders and stockbrokers can trade stocks, bonds, and other securities. Stock exchanges also provide places for the issuance and redemption of securities and other financial contracts, as well as capital events like the payment of income and dividends. As a matter of course, the initial offering of stocks and bonds to investors is accomplished in the primary market, while successive trading occurs in the secondary market. Within stock markets, supply and demand are steered by the variety of factors that affect the price of stocks in all free markets.

TERMS TO KNOW

Preemption

The right of a shareholder to purchase newly issued shares of a business entity before they are available to the general public so as to protect individual ownership from dilution.

Stock Exchange

A form of exchange that provides services for stockbrokers and traders to trade stocks, bonds, and other securities.

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4. Preferred Stock Rules and Rights

Preferred stock usually carries no voting rights, but may carry a dividend and may have priority over common stock in the payment of dividends and upon **liquidation**. Terms of the preferred stock are stated in a "Certificate of Designation."

Preferred stock is a special class of shares with a unique set of features distinct from common stock, including:

- Preference in dividends and liquidation assets
- Convertibility to common stock
- Callability feature at the discretion of the issuer
- No voting rights (though some preferred shares have special voting rights in the case of an election of directors or extraordinary events like the issuance of new shares or approval of the acquisition of a company)

HINT

It should be noted, however, that in a case in which preferred dividends are in arrears for a considerable time, preferred shares may be able to gain voting rights.

As mentioned previously, in the event of a company's liquidation, preferred stock may or may not have a fixed liquidation value, or par value, assigned to it. This face value comprises the amount of capital contributed to the company at the time of the shares' issuance. Upon a corporation's liquidation, preferred stock can claim proceeds equal to its par (or liquidation) value, except if this was negotiated in a different manner. This claim takes precedence over the claim of common stock, which only has a residual claim. Virtually all preferred shares have a negotiated, fixed dividend amount, which is stated as a percentage of the par value, or as a fixed amount; however, occasionally dividends on preferred shares are negotiated as floating, meaning they may vary based upon a benchmark interest rate index.

TERM TO KNOW

Liquidation

The process by which a company (or part of a company) is brought to an end, and the assets and property of the company redistributed.

5. Provisions of Preferred Stock

Preferred stock may be entitled to numerous rights, depending on what is designated by the issuer. One of these rights may be the right to cumulative dividends. Preferred stock shareholders already have rights to dividends before common stock shareholders, but cumulative preferred shares contain the provision that should a company fail to pay out dividends at any time at the stated rate, then the issuer will have to make up for it as time goes on.

Convertible preferred stock can be exchanged for a predetermined number of company common stock shares. Generally, this can occur at the discretion of the investor, and he or she may pick any time to do so and, therefore, take advantage of fluctuations in the price of common stock. Once converted, the common stock cannot be converted back to preferred status. Oftentimes, companies will keep the right to call or buy back preferred shares at a predetermined price. These shares are callable shares.

Participating preferred stock is a class of preferred shares that provide shareholders the chance to receive extra dividends, contingent upon the company reaching predetermined financial goals. Investors who buy these stocks receive their regular dividends even if the company does not reach those predetermined goals, as long as the company succeeds enough to make its annual dividend payments; however, if the company does reach those sales, earnings or profitability goals, the investors receive a bonus dividend.

Virtually all preferred shares have a negotiated, fixed dividend amount, which is stated as a percentage of the par value, or as a fixed amount; however, occasionally dividends on preferred shares are negotiated as floating, meaning they may vary based upon a benchmark interest rate index or floating rate (e.g., linking the dividend rate to LIBOR).

TERMS TO KNOW

Convertible Preferred Stock
Stock that can be exchanged for a predetermined number of company common stock shares.

Participating Preferred Stock
Stock that provides shareholders the chance to receive extra dividends, contingent upon the company reaching predetermined financial goals.

6. Comparing Common Stock, Preferred Stock, and Debt

6a. Equity

Common stock and preferred stock are both methods of purchasing equity in a business entity.

Common stock generally carries voting rights along with it, while preferred shares generally do not.

Preferred shares act like a hybrid security, in between common stock and holding debt. Preferred stock can (depending on the issue) be converted to common stock and have access to accumulated dividends and multiple other rights. Preferred stock also has access to dividends and assets in the case of liquidation before common stock does.

However, both common and preferred stock fall behind debt holders when it comes to claims to assets of a business entity should bankruptcy occur. Common shareholders often do not receive any assets after bankruptcy as a result of this principle. However, common stock shareholders can theoretically use their votes to affect company decision making and direction in a way they believe will help the company avoid liquidation in the first place.

6b. Debt

Debt can be "purchased" from a company in the form of a bond. In the context of finance, a bond is a contract of indebtedness, issued by the bond issuers to the bondholders. It is a debt security with a framework outlined as follows: the bond issuer owes the bondholder a debt, and contingent on the bond terms, is required to pay them interest and/or repay the principal at a later time, known as the maturity date. Put another way, a bond is simply a form of loan or IOU, in which the issuer of the bond is the borrower or debtor, the holder of the bond is the lender or creditor, and the coupon represents the interest.

Bonds are a source of external funds to finance long-term investments or can be used to finance current expenditures, as in the case of government bonds. Even though bonds and stocks are both securities, there are several major differences between them:

- Capital stockholders have an equity stake in the company, meaning they are owners, while bondholders have a creditor stake in the company, meaning they are lenders.
- Bonds generally have a defined term (maturity), at which point the bond is redeemed, while stocks may be outstanding forever.

SUMMARY

In this lesson, you learned in greater detail about the ownership rights associated with common stock and preferred stock. Both have a **claim to income** from dividends and capital appreciation, but the claims of preferred stock take precedence over those of common stock. In exchange, common stock owners have **voting rights** that exceed those of preferred stockholders. Stock ownership usually also comes with rights regarding the **purchase of new shares**. **Preferred stock** has different **rules and rights** than common stock when it comes to voting, dividends, and valuation, and it may have a number of additional **provisions** regarding cumulative or extra dividends and convertibility. When **comparing common stock, preferred stock, and debt**, however, it is important to note that both types of stock represent **equity** or ownership in the company, whereas **debt** is a long-term loan with a fixed maturity date.

Best of luck in your learning!

TERMS TO KNOW

Convertible Preferred Stock
Stock that can be exchanged for a predetermined number of company common stock shares.

Liquidation

The process by which a company (or part of a company) is brought to an end, and the assets and property of the company redistributed.

Participating Preferred Stock

Stock that provides shareholders the chance to receive extra dividends, contingent upon the company reaching predetermined financial goals.

Preemption

The right of a shareholder to purchase newly issued shares of a business entity before they are available to the general public so as to protect individual ownership from dilution.

Stock Exchange

A form of exchange that provides services for stockbrokers and traders to trade stocks, bonds, and other securities.

Voting Rights

Rights that are generally associated with common stock shareholders in regards to business entity matters (such as electing the board of directors or establishing corporate policy).