Venture Capital Investing: Can the Liquidation Preference of Preferred Stock Over the Common Stock be Protected Where the Common Stock Receives Little or Nothing in an Exit?

The board of directors of a venture-backed company often includes directors elected by venture capital holders of preferred stock, the company’s CEO and one or more founders as the members elected by the common stockholders, and perhaps one or more independent directors elected by the preferred stockholders and common stockholders voting together as a single class. When there have been several rounds of preferred stock investments, the directors elected by the venture capital investors are likely to comprise a majority of the board.

This common situation would appear to give the directors elected by the venture capital investors constituting a majority of the board the right to approve a sale of a company, even if the aggregate liquidation preference of the preferred stock would consume the entire proceeds of the sale.

By way of example, assume a company has issued preferred stock with an aggregate liquidation preference of $40 million with respect to proceeds from a sale of the company. After eight years in operation, it becomes clear that, although the company has value to a strategic buyer, it will never be a candidate for an initial public offering and its upside is limited. The venture capitalists no longer wish to fund the company, alternative sources of financing on terms acceptable to each of the common and preferred are not available, a majority of the board determines that selling the company is the best strategic option, and the company hires an independent investment bank to conduct a sale process to solicit the highest price for selling the company. Following an extensive sale process, the best offer is $30 million. The directors elected by the preferred stock — who constitute a majority of the board — want to take the offer because they believe that the upside prospects for the company are highly speculative. The investment bank has orally advised that $30 million is a fair price.

One might assume that these directors would prevail in any challenge to the board’s approval of the transaction.
The capital structure — which has been agreed upon by both holders of preferred stock and common stock and is set forth in the company’s charter — provides a contractual waterfall with respect to the proceeds of a sale transaction, and the board intends to follow those provisions.

However, for those companies incorporated in Delaware or any jurisdiction that follows Delaware corporate law, two recent decisions of the Delaware Chancery Court imply that the board decision to sell the company could be evaluated under the “entire fairness” standard rather than the much more comforting “business judgment” rule. To date, there is no developed consensus regarding an effective approach for avoiding or easily defeating claims by common stockholders that a board with a majority of preferred stockholder representatives unfairly favored the preferred by pursuing the sale of the company at a time when the sale proceeds will be used to satisfy the preferreds’ liquidation preferences and little or nothing will be paid to the common.

In this Client Alert, we will describe the two decisions briefly and then assess the efficacy of methods to address the issues raised by the decisions.

The Delaware Court Decisions

**In re Trados Incorporated Shareholder Litigation**

In *In re Trados Incorporated Shareholder Litigation*, the board of directors approved a merger of the company in which the preferred stockholders received a portion of their liquidation preference, management received a percentage of the merger proceeds pursuant to a management incentive or “carve-out” plan, and no merger consideration remained for the common stockholders. The plaintiff, a common stockholder, alleged that the company was a viable business, the common stockholders would have been able to secure consideration for their shares in a future transaction had the merger not occurred and that the interests of the common and preferred stockholders diverged over the board decision to pursue an immediate sale of the company on terms that would trigger the liquidation preference of the preferred stockholders and leave no sale proceeds for the common stockholders.

The case came before the Delaware Chancery Court on a motion to dismiss before there had been any trial, so the court was obligated to assume that the facts alleged by the plaintiff was true. The court declined to dismiss the breach of fiduciary claims raised by the plaintiff because the plaintiff had alleged facts demonstrating that a majority of the board was designated by the venture capital holders of preferred stock, those directors owned preferred stock personally or had significant affiliations with the venture capital holders of preferred stock that would receive substantially all of the company sale proceeds, and the preferred stockholders desired to exit their investment at a time when the common stockholders had no interest in selling the company. The court declined to dismiss the complaint because the common stockholder plaintiff had alleged that a majority of the directors were unable to exercise independent and disinterested business judgment in deciding whether to approve the sale of the company at the time and on those terms.

The significance of the *Trados* decision to investors in preferred stock is that their designees to the board of directors may not be considered independent and disinterested in making a determination to sell the company where the preferred stockholders will receive all of the transaction consideration and it is possible that the common stockholders would receive some consideration if the company were permitted to continue and pursue an alternate liquidity event.
at a future date. Under Delaware law, this means that such a transaction might not be reviewed under the more deferential business judgment rule and would instead be subject to review under the entire fairness standard, with the burden on the board members to prove that the transaction is procedurally and economically fair to the common stockholders. The time and cost of proving that result may be a serious deterrent to any potential buyer which may not want to take on the potential legal fees, much less potential ultimate liability, of such litigation. Accordingly, the Trados decision may not just make things more difficult legally; it can also interfere with the transaction opportunity and economics of a potential sale of the company.

It is important to emphasize that customary sales processes designed to address board fiduciary duty obligations, including procedures to maximize the selling price, and the receipt of a fairness opinion from an investment bank, do not directly address the director conflict concerns raised by the Trados decision. The court in Trados explicitly noted that, although the interests of the preferred and common stockholders may have been aligned, or at least not opposed, in seeking to maximize the price for the company, the conflict of interest was posed by the threshold decision of whether to pursue a sale or to continue to operate without pursuing a sale at that time.

Accordingly, even assuming the sale process is not subject to legitimate criticism, evidence that the board received a “fair” price might not be sufficient for dismissal on a pre-trial motion of a claim early in the court proceedings. The common stockholders may therefore be able to threaten the directors (and their indemnifying venture capital funds) with a trial on the claim that the sale was done solely to benefit the preferred stockholders to the detriment of the common stockholders in a transaction where the common stockholders will receive nothing.

For a venture-backed company with the typical board composition, the Trados decision therefore potentially means that a sale where all or substantially all of the proceeds go to the preferred stockholders may be viewed as a “conflict of interest” transaction. The usual way to deal with such a conflict transaction is for the interested and non-independent directors to stay out of the process and call for a vote of the “independent” or “disinterested” directors, who in this case would likely be the directors elected by the common stockholders and any directors elected by the common and preferred stockholders voting together who are not otherwise affiliated with the preferred stockholders. Approval of the transaction by disinterested directors, a committee consisting of disinterested directors or the independent stockholders may be effective to restore the more lenient business judgment rule protection for the board decision or at least shift the burden of proof to those attacking the transaction. However, while venture capital investors can clearly seek the vote of the disinterested directors or stockholders, if the common stockholders will receive no or minimal proceeds in the sale transaction and, therefore, have no downside risk from continuing the company, the directors who are elected by the common stockholders may choose not to approve such a transaction.

In addition, the potential difficulty of obtaining the vote of “independent” directors in favor of a transaction that provides little or no consideration for the common stock is exacerbated by another recent Delaware decision, LC Capital Master Fund.

**LC Capital Master Fund, Ltd. v. James**

In *LC Capital Master Fund, Ltd. v. James*, the company’s charter was drafted in an unusual manner so that the liquidation preferences of the preferred stock did not apply in a
merger. Instead, under the company’s charter, the preferred stockholders had the choice of receiving the consideration specified in the merger agreement or the same merger consideration, on an as-converted-to-common basis, as the common stockholders. Pointing to economic rights under the charter that were held by the preferred shares outside the merger context, the preferred stockholders argued that the board of directors had a fiduciary duty, rather than a contractual obligation under the charter, to allocate more of the merger consideration to the preferred stockholders.

The court held that where contractual rights of the preferred stockholders in a merger are defined in the charter, and the board fully satisfies its duties to the preferred stockholders by honoring those contractual rights, the board owes the preferred stockholders no duty to reallocate merger consideration to benefit the preferred stockholders at the expense of the common stockholders. In arguable contrast to the Trados decision, the court rejected the argument that directors who owned immaterial amounts of common stock and in-the-money options to purchase common stock were conflicted because the allocation of merger consideration did not account for the value of the preferred stock’s economic rights outside the merger context.

At first look, LC Capital Master Fund may not seem troubling in the normal situation where the charter provisions will assure the preferred stockholders their liquidation preferences in a merger transaction. However, the court recognized the duty of directors to pursue the best interests of the company and the common stockholders, if that can be done faithfully with the contractual rights of the preferred stockholders, and that once the contractual rights of the preferred stockholders are honored, the board’s fiduciary duties to the preferred stockholders are fully satisfied and any fiduciary duties with respect to the matter are owed solely to the common stockholders. This holding arguably provides a basis for directors unaffiliated with the preferred stockholders simply to vote against a transaction like the one in our example, where the contractual rights of the preferred stockholders do not dictate a sale and the common stockholders will receive nothing in the sale transaction.

Coupled with the Trados decision, where the preferred-designated directors may be considered interested and to possess a disqualifying conflict on the decision to sell the company, there are questions about how to insulate from challenge a sale where the common stockholders receive no or minimal proceeds unless the company is on the verge of bankruptcy. Barring harm to the enterprise from doing so, LC Capital Master Fund will be used by common stockholders to contend that the independent directors may be obligated to try to keep the company alive in hopes that there will at some point be a transaction that provides proceeds to the common stockholders.

In short, common stockholders will argue that the Trados and LC Capital Master Fund decisions stand for the principle that, where the company’s charter expressly defines the rights of the preferred stock, the board is obligated only to fulfill those rights to the extent they are triggered and its fiduciary duties with respect to discretionary matters run solely to the common stockholders.

Solutions That Have Been Advanced

There has been no perfect solution advanced to date for the dilemma posed by these court decisions. The approaches that we believe have the highest probability of being effective must be employed at the time of a financing in which the investors have
significant leverage. However, even these approaches may not be practical.

One approach would be to assure that there are enough independent directors to outvote the directors elected by the common stockholders. This is not a complete fix because, as described above, the Delaware court decisions may lead those independent directors to avoid voting in favor of a transaction where the common stockholders receive no or minimal proceeds, no matter how justified. Moreover, it is often difficult to find qualified independent directors, and it would be unfortunate to change the dynamic of the board by creating a large board simply to address this one potential situation.

Some commentators have suggested that there is a potential solution in making the preferred stock redeemable at the option of the holders of a certain percentage of the preferred if certain milestones are not reached or if the company is not sold within the investors’ investment horizon. This approach raises a number of issues. First, there are legal limitations on a company’s financial ability to redeem preferred stock, so the preferred stock may not be redeemable in full at the time the preferred stockholders want to sell the company. Under the Delaware court decisions described above, the preferred stockholders will have no way to force the board to sell the company if necessary in order to accomplish the redemption. Furthermore, the existence of redeemable preferred stock alters the company’s capital structure from an accounting perspective, which could interfere with the company’s ability to appear viable to its customers. There also may be tax issues associated with redeemable preferred stock, as well as prohibitions or limitations under a company’s credit agreements.

A variation in this approach involves the negotiation, at the time of the investment in preferred stock, of a contractual commitment by the company to commence a sale process upon request by the preferred stockholders coupled with a right to put (i.e., sell back) the preferred stock in exchange for its liquidation preference in the event that a sale is identified but not approved by the board of directors. While this does avoid the requirement for a vote to initiate a sale process by the board of directors, the board will ultimately have to approve and recommend a sale so it is not clear that this eliminates the Trados director conflict issue for the board. In addition, it addresses neither the legal limitations on redemption of stock under Delaware law (since there will often be no financial ability to redeem the preferred stock absent a sale of the company which in turn requires the vote of the board) or the accounting and tax issues associated with redeemable preferred stock.

Another potential solution is an airtight drag-along provision that obligates each and every company stockholder (and holders of stock options or warrants upon exercise) to vote in favor of, and participate in, a sale transaction that is approved by the preferred stockholders even if the transaction is not approved by the board. This drag-along would need to be negotiated at the time of the investment in the preferred stock. However, there are also significant issues with this approach. First, it may not be possible to get every stockholder to agree to the drag-along provisions (e.g., if the venture capitalists invest after certain common stockholders no longer work for the company, it would be difficult or impossible to obtain those holders’ agreement to be bound by the drag-along). More importantly, the buyer may not want to acquire the company in a stock purchase, and any merger or sale of assets will require board approval, which may pose all of the director conflict problems raised by Trados despite the existence of the drag-along.

Finally, and perhaps most promising, the charter of the company could provide
that the company would be sold at the election of the preferred stockholders in the event that specific economic or other milestones are not achieved. To be effective, the investors would be well-advised to negotiate these provisions of the charter in connection with their investment and to make sure that the charter provisions are approved by the holders of a majority of the common stock. With these charter provisions in place, the board members would hopefully be seen by a court as merely fulfilling their contractual duties under the charter as opposed to exercising a discretionary decision to which their fiduciary duties would apply.

All is Not Lost Even if These Suggested Solutions Cannot Be Implemented

Even if none of the suggested solutions can be implemented, there are things that can be done to assuage the issues raised by Trados and LC Capital Master Fund. Although the following actions may not solve the fundamental director conflict of interest issue addressed in Trados, as described above, they may improve a court’s overall view of the board’s decision to sell the company:

• Ascertaining whether alternate funding to continue the company’s operations is available either from existing investors or from new investors, and potentially hiring a financial advisor to pursue such alternate funding opportunities. This may demonstrate that no real alternative to sale existed.
• If no such alternate funding is available, forming a committee of independent directors to supervise the process for selling the company.

• Obtaining a fairness opinion from an investment banker as to the fairness of the aggregate consideration to be received for the company.
• If confident of the vote, making the sale conditioned on approval of the holders of a majority of the common stock who are disinterested (i.e., excluding employees who will have change of control bonuses or be employed by the acquirer).

Endnotes

2 This burden of proof may run not only in favor of the common stockholders, but also in favor of any series of junior preferred stock that does not receive proceeds of the sale transaction due to its inferior position in the company’s distribution waterfall.
3 The normal acquisition agreement provides that the buyer will indemnify the directors of the selling company. We are aware of at least one transaction where the buyer successfully negotiated for the elimination of such indemnification (and received an indemnification from the selling preferred stockholders in respect of any amounts required to be paid under the indemnification provisions of the target’s bylaws, which could not be similarly eliminated) as a means of reallocating the risk of post-closing fiduciary duty claims in a situation like Trados.
4 If the CEO will receive a change of control bonus in connection with the transaction or be employed by the acquirer following the transaction, the CEO may also be “interested” in the transaction.
5 990 A.2d 435 (Del. Ch. 2010).
6 The LC Capital Master Fund case was not the first in which Delaware courts have held that the rights of preferred stockholders are primarily contractual in nature, and is consistent with this general principle of Delaware law.
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