

“What keeps you up at night?”

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Delaware court refuses to extend rights of preferred stockholders

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SUMMARY

In an unpublished decision handed down last week, the Delaware courts once again confirmed that when the rights of preferred and common stockholders diverge, the Board ultimately owes its fiduciary duties to the common stockholders. The case involved a dispute over the allocation of merger consideration between the preferred and common stockholders of the acquisition target. The court permitted the merger consideration to be allocated among them on an as-converted basis, and declined to force the acquisition target's board to allocate more of the consideration to the preferred holders notwithstanding the preferred holders' argument that the special attributes of the preferred stock ought to have entitled them to receive a larger share of the consideration. This decision and its brethren send a cautionary message to angel/venture investors — particularly those with Board representatives.

A recent opinion of the Delaware Chancery Court should be of interest to preferred stock investors and to board members, management and others with connections to venture-backed companies. The unpublished opinion, *LC Capital Master Fund, Ltd. v. James* (Del.Ch. March 8, 2010) dealt with the allocation of merger consideration among preferred stockholders and common stockholders of a Delaware corporation that was a merger target.

QuadraMed Corporation, the corporation at issue, had outstanding common stock and preferred stock. A certificate of designation provided that the preferred stock had the following attributes:

- Each share of preferred stock was convertible into 1.6129 shares of common stock
- A right to receive certain dividends, but payable only "when, as and if authorized and declared by the board"
- A liquidation preference of \$25 per share plus accrued dividends, payable upon the occurrence of a liquidation event— however, an acquisition of QuadraMed by merger expressly did **not** constitute a liquidation event that would trigger the payment of the preference
- Certain approval rights, including a right to consent to certain kinds of amendments to QuadraMed's certificate of incorporation and a right to consent to QuadraMed incurring certain levels of long-term senior indebtedness— however, neither these

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approval rights nor anything else in QuadraMed's charter afforded the preferred stockholders any right to vote on, consent to or veto an acquisition of QuadraMed by merger

QuadraMed's board received an offer from a third party to acquire the company by means of an all-cash merger. QuadraMed's board, after forming a special committee of independent directors to evaluate the offer, determined to accept it and recommend it to the shareholders for approval. The offer contemplated that common shareholders would receive \$8.50 per share and preferred shareholders would receive \$13.7097 per share (i.e., the consideration they would have received had all of the preferred stock been converted into common).

A preferred stockholder sought to enjoin the transaction from proceeding, on the basis that QuadraMed's board had violated fiduciary duties owed to the preferred stockholder by approving the allocation of merger consideration among common and preferred stockholders on an as-converted basis instead of requiring more of the consideration to be allocated to the preferred stockholders. The preferred stockholder argued that QuadraMed's board should have assigned some value to the attributes of the preferred stock beyond the as-converted transaction value of the stock, and that the failure to do so constituted a breach of the board's fiduciary duties to the preferred stockholders. Significantly, the preferred stockholder did not challenge the board's acceptance of the offered purchase price for the company as a whole, but only the allocation of that purchase price between the preferred and the common.

The Delaware Chancery Court declined to grant the injunction. Vice Chancellor Strine wrote that, "When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor. To the extent that the board does so, it need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common."

The opinion teaches that if the corporation's charter documents provide that preferred holders do not have the express contractual

right to receive a certain premium in a transaction for their preferred shares, nor do they have a right to veto or obstruct a transaction that would do away with attributes of their preferred shares, the preferred holders should not expect to be able to insist upon receiving that premium in the transaction. In other words, if a given transaction does not expressly entitle preferred stockholders to a preference, and the preferred stockholders lack the ability to block the transaction, it is likely that attributes of the preferred stock that are not relevant to the transaction (such as, for example, a right to receive a liquidation preference when the transaction does not trigger the payment of that preference) will be of no value when the determination is made as to how to allocate the transaction consideration among the preferred stockholders and other stockholders. The opinion makes clear that extreme care is necessary in anticipating issues and stating with complete clarity any and all rights for preferred, because a court will impute no additional rights.

This opinion, and the body of law from which it is derived, should be kept in mind both by preferred stock investors and by companies that seek preferred stock financing as they negotiate and document equity transactions. For more information, contact the author or any member of the firm's Technology, Emerging Companies and Capital Practice Group.

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