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First Principles for Addressing the Competing Interests of Common and Preferred Stockholders in an M&A Transaction

When engaged by a Delaware corporation with a common and preferred stock capital structure to provide advice in an M&A transaction, counsel should expect to face a complicated array of legal issues posed by the potentially competing nature of the interests of the common and preferred stockholders. Among other issues, counsel will be expected to advise the board on (i) how to account for the frequently competing, occasionally antagonistic, interests of common and preferred stockholders, (ii) how to overcome, or insulate the board from, potential conflicts within the boardroom, and (iii) the process to be used for determining the allocation of merger consideration among the common and preferred. In connection with such an M&A transaction, board counsel will be expected to provide clear and reliable guidance on these issues.

This primer sets forth a series of "first principles" to be considered when providing advice to boards of directors on their obligations in connection with M&A transactions involving common and preferred stock. Among other things, the primer addresses the contractual nature of preferred stock, whether the contractual rights of preferred stock may be negated or compromised, how the contractual rights of preferred stock intersect with the board's fiduciary duties, and whether there are circumstances in which the board may favor the interests of common stockholders over those of preferred stockholders.

Fiduciary Duties of Directors

Under Delaware law, directors manage the business and affairs of the corporation.[1] In fulfilling their managerial responsibilities, directors of Delaware corporations are charged with a fiduciary duty to the corporation and to all the corporation's stockholders.[2] The fiduciary obligations of directors fall into two broad categories:

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1 8 *Del. C.* § 141(a).

2 Directors of Delaware corporations owe fiduciary duties to all stockholders of the corporation they serve, not just to the holders of the particular class or series of stock that elected them. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("Signal designated directors on UOP's board still owed UOP and its shareholders an uncompromising duty of loyalty."); *Phillips v. Insituform of N. Am. Inc.*, 1987 WL 16285, at *10 (Del. Ch. Aug. 27, 1987) ("The law demands of directors ... fidelity to the corporation and all its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them...").

(i) the duty of care, and (ii) the duty of loyalty. The duty of care essentially requires directors to be attentive and to inform themselves of all material facts regarding a decision before taking action. The duty of loyalty, on the other hand, requires that directors' actions be motivated solely by the best interests of the corporation and its stockholders. The duty of good faith is a "subsidiary element" of the duty of loyalty,[3] said to "involve all aspects of honesty and integrity"[4] and to require that directors be motivated solely "by a true faithfulness and devotion to the interests of the corporation and its shareholders."[5] A failure to act in good faith (i.e., bad faith) may be evidenced by an actual intent to do harm to the corporation or its stockholders or by an "intentional dereliction of duty, a conscious disregard for one's responsibilities," such as intentionally failing to act in the face of a known duty.[6]

The Contractual Nature of Preferred Stock

In general, all shares of capital stock of a corporation are equal at common law, and the preferences enjoyed by preferred owners exist only through express provisions in the "contract" between the corporation and its preferred stockholders.[7] Accordingly, "to ask what are the rights of the preferred stock is to ask what are the rights and obligations created contractually by the certificate of designation."[8] However, even absent such express provisions in the contract, preferred stock has certain residual rights (beyond the contract) that exist:

> [W]ith respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty

3 *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

4 E. Norman Veasey, *Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions*, 37 Bus. Law. 1247, 1251 (1982).

5 *In re Walt Disney Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006); *see also In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989).

6 *In re Walt Disney Derivative Litig.*, 906 A.2d 27, 64, 66 (Del. 2006); *see also Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 244 (Del. 2009) (holding that the proper inquiry when deciding whether independent and disinterested directors had breached the duty of loyalty by failing to act in good faith was to consider whether they "utterly failed" to undertake their responsibilities). Bad faith will not, standing alone, directly result in a finding of personal liability. Rather, it will simply satisfy one element of a breach of the duty of loyalty. *Stone*, 911 A.2d at 370.

7 *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593 (Del. Ch. 1986); *see also Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997) (stating that "special protections offered to the preferred are contractual in nature"); *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 937 (Del. 1979) (finding that, with respect to the conversion privilege, the rights of a preferred stockholder are "least affected by rules of law and most dependent on the share contract").

8 *HB Korenvaes Invs., L.P. v. Marriott Corp.*, 1993 WL 205040, at *5 (Del. Ch. June 9, 1993); *see also Rothschild Int'l Corp. v. Liggett Group, Inc.*, 474 A.2d 133, 136 (Del. 1984) (holding that "preferential rights are contractual in nature and therefore are governed by the express provisions of a company's certificate of incorporation").

> is appropriately defined by reference to the specific words evidencing that contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such right and the scope of the correlative duty may be measured by equitable as well as legal standards.[9]

Therefore, according to *Jedwab*, when a board is analyzing the rights of preferred stockholders, the threshold question is whether an asserted right of the preferred is contractual (a "preferred right") or equitable (a "residual right").

The Delaware courts, however, have not articulated a "bright-line" rule to aid directors in this determination. Rather, the answer depends upon the facts and circumstances generating the issue.[10] Generally, however, contractual principles will govern disputes that arise out of either circumstances referred to in the contract or rights created by the contract.[11] It is appropriate, therefore, to consider the rules of construction that the Delaware courts will apply when resolving such disputes.

The Rules of Contract Construction

When construing the rights afforded preferred stockholders by the terms of a certificate of incorporation or designation, a Delaware court first will look to general principles of contract construction.[12] The court will "consider the entire instrument and attempt to reconcile all of its provisions 'in order to determine the meaning intended to be given to any portion of it.'"[13] The special rights granted to holders of preferred stock will be strictly construed, must be clearly expressed, and will not be presumed.[14] As such, "[f]or most purposes, the rights of the preferred shareholders as against the common shareholders are fixed by the contractual terms agreed upon when the class of preferred stock is created."[15] Thus, it has been held that preferred stockholders, "insofar as the rights of preference against the common stock are concerned ... are not owed a duty of loyalty, even if they may be

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9 *Jedwab*, 509 A.2d at 594.

10 *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, 1995 WL 662685, at *6 (Del. Ch. Nov. 2, 1995).

11 *Id.*

12 *See NBC Universal, Inc. v. Paxson Commc'ns Corp.*, 2005 WL 1038997, at *5 (Del. Ch. Apr. 29, 2005).

13 *Wood*, 401 A.2d at 937 (quoting *Ellingwood v. Wolf's Head Oil Refining Co.*, 38 A.2d 743, 747 (Del. 1944)).

14 *Staar Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991); *Rothschild Int'l Corp. v. Liggett Group Inc.*, 474 A.2d 133, 136 (Del. 1984); *Wood*, 401 A.2d at 937; *Judah v. Delaware Trust Co.*, 378 A.2d 624, 628 (Del. 1977); *Ellingwood*, 38 A.2d at 747; *Warner Commc'ns, Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962 (Del. Ch. 1989), *aff'd*, 567 A.2d 419 (Del. 1989) (TABLE).

15 *Wood*, 401 A.2d at 937 (Del. 1979). The terms of the preferred stock are interpreted by the same rules used to interpret statutes, contracts and other written instruments. *Hibbert v. Hollywood Park Inc.*, 457 A.2d 339, 342-43 (Del. 1983). Provisions unambiguous in their language are to be given effect as written. *Id.*

owed a contractual duty of good faith."[16] Directors, in other words, "do not owe preferred shareholders any fiduciary duties with respect to [preferential] rights."[17] Once the board of directors honors the contractual right to a preference, it owes no additional obligations with respect to such preference.[18]

When a provision is unambiguous, the court will give effect to the language as written,[19] and "any ambiguity must be resolved against granting the challenged preferences, rights or powers."[20] While the Delaware courts have found that an implied covenant of good faith and fair dealing is evident in all contracts, including certificates of incorporation, the courts have rejected attempts to use the covenant of good faith and fair dealing to presume preferential rights of preferred stock that are not clearly expressed.[21]

Boards May Avoid Triggering or May Affirmatively Negate Preferred Stock Voting Rights

Applying these rules of construction, the Delaware courts have, on a number of occasions, permitted companies to undertake transactions designed to avoid triggering or to affirmatively negate protective provisions of preferred stock. For example, there is a "long line of Delaware cases which, in general terms, hold that protective provisions drafted to provide a class of preferred stock with a class vote before those shares' rights, preferences and privileges may be altered or modified do not fulfill their apparent purpose of assuring a class vote if adverse consequences flow from a merger and the protective provisions do not expressly afford protection against a merger."[22] Thus, in *Warner Communications*,[23] the Court of Chancery considered whether the holders of a series of preferred stock

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16 *Glinert v. Wickes Cos., Inc.*, 1990 WL 34703, at *9 (Del. Ch. Mar. 27, 1990) (citing *Jedwab*, 509 A.2d 584), *aff'd*, 586 A.2d 1201 (Del. 1990) (TABLE); *Fletcher Int'l, Ltd. v. ION Geophysical Corp.*, 2010 WL 2173838, at *7 (Del. Ch. May 28, 2010); *MCG Capital Corp. v. Maginn*, 2010 WL 1782271, at *15 (Del. Ch. May 5, 2010).

17 *MCG Capital Corp.*, 2010 WL 1782271, at *15; *see also Fletcher*, 2010 WL 2173838, at *7.

18 *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 449 (Del. Ch. 2010); *MCG Capital Corp.*, 2010 WL 1782271, at *15.

19 *Hibbert*, 457 A.2d at 342-43.

20 *In re Sunstates Corp. S'holder Litig.*, 788 A.2d 530, 533 (Del. Ch. 2001) (citing *Sullivan Money Mgmt., Inc. v. FLS Holdings, Inc.*, 1992 WL 345453, at *5 (Del. Ch. Nov. 20, 1992)).

21 *Id.* at 535 (analyzing a protective provision that prohibited the repurchase of shares of preferred stock of a corporation while dividends were in arrears and refusing to find that the purchase of such shares by a subsidiary of the corporation, when the charter did not specifically prohibit purchases by subsidiaries, was a violation of the implied covenant of good faith and fair dealing); *see also Quadrangle Offshore (Cayman) LLC v. Kenetech Corp.*, 1999 WL 893575 (Del. Ch. Oct. 13, 1999) (analyzing a protective provision providing certain rights to the preferred stock upon liquidation and refusing to find that the directors of a corporation had violated a covenant of good faith and fair dealing by structuring a transaction, which the preferred stockholder alleged was a "de facto" liquidation, to avoid triggering the protective provision), *aff'd*, 751 A.2d 878 (Del. 2000) (TABLE).

22 *Benchmark Capital Partners IV, L.P. v. Vague*, 2002 WL 1732423, at *7 (Del. Ch. July 15, 2002).

23 583 A.2d 962 (Del. Ch. 1989), *aff'd*, 567 A.2d 419 (Del. 1989).

were entitled to a class vote when the charter was amended via merger (rather than by the traditional means of a certificate of amendment) to adversely affect the terms of the preferred stock. In *Warner*, the charter expressly required a class vote of a particular series of preferred stock before the corporation could "amend, alter or repeal any of the provisions of the Certificate of Incorporation or By-laws of the Corporation so as to affect adversely any of the preferences, rights, powers or privileges of the Series B Stock or the holders thereof...."[24] The Court noted the distinction between the Delaware statutory provision governing charter amendments (Section 242) and the one governing mergers (Section 251),[25] concluding that it was unlikely that the draftsmen, "who obviously were familiar with and probably expert in our corporation law," would have chosen language that so closely tracked Delaware's statutory provision governing amendments to a charter "had they intended a merger to trigger the class vote mechanism of that section."[26]

The Delaware Supreme Court subsequently adopted the reasoning of *Warner* when it provided guidance on how to draft charter provisions to require a class vote for a charter amendment accomplished by a merger. In *Avatex*,[27] the Delaware Supreme Court found that the charter provision at issue in that case was drafted properly to require a class vote of a series of preferred stock to approve an amendment accomplished by merger. The charter provision specifically provided for a class vote of a series of preferred stock in the event of any "amendment, alteration or repeal, *whether by merger, consolidation or otherwise*, of the Restated Certificate of Incorporation ... which would materially and adversely affect any right, preference, privilege or voting power of the First Series Preferred Stock or of the holders thereof ...."[28] The Delaware Supreme Court found that this language was sufficient to trigger a class vote for a merger, explaining:[29]

> The path for future drafters to follow in articulating class vote provisions is clear. When a certificate (like the Warner certificate or the Series A provisions here) grants only the right to vote on an amendment, alteration or repeal, the preferred have no class vote in a merger. When

24 *Id.* at 965.

25 The voting requirements for mergers of domestic stock corporations are generally set forth in Section 251(c) of the General Corporation Law and do not provide for a class vote to approve a merger (absent a charter provision creating that right). 8 *Del. C.* § 251(c). The voting requirements for charter amendments are set forth in Section 242(b) of the General Corporation Law, which contemplates a class vote in certain circumstances as a matter of law (in addition to any class vote required by the terms of the charter). 8 *Del. C.* § 242(b).

26 *Warner*, 583 A.2d at 970; s*ee also Benchmark*, 2002 WL 1732423, at *9 (finding that the holders of junior preferred stock would not have any class voting rights in connection with changes to a certificate of incorporation to be effected pursuant to a proposed merger, notwithstanding that those changes would affect the rights and preferences of the junior preferred stock adversely, because the terms of the junior preferred stock did not expressly confer class voting rights in connection with a merger).

27 *Elliott Associates, L.P. v. Avatex*, 715 A.2d 843 (Del. 1998).

28 *Id.* at 845 (emphasis added).

29 The Court found it important that the drafters included the term "consolidation" which contemplates a transaction in which the charter of the corporation would not be amended. Thus, the Court reasoned that the drafters must have intended to require a vote on a merger that effectively repealed the charter and adversely affected the series of preferred stock, regardless of whether the charter was actually amended in the merger. *Id.* at 851.

> a certificate (like the First Series Preferred certificate here) adds the terms "whether by merger, consolidation or otherwise" and a merger results in an amendment, alteration or repeal that causes an adverse effect on the preferred, there would be a class vote.[30]

In light of *Warner*, *Avatex*, and similar cases,[31] when advising a board in connection with a transaction, counsel should consider whether the board may have an obligation to structure the transaction in a manner that avoids triggering (or affirmatively negates) protective provisions of the preferred stock.

The Intersection of Contractual Rights and Fiduciary Duties

In the absence of an express preference addressing an issue in dispute, counsel will be expected to determine what, if any, residual fiduciary duties a board of directors owes to preferred stockholders in a particular context. As previously stated, *Jedwab* creates a second category of "shared rights" for preferred owners that exist equally amongst preferred and common stockholders,[32] and therefore impose upon the board an equal duty of care and loyalty to both constituencies.[33] Delaware decisions finding that a preferred stockholder properly stated a claim for breach of fiduciary duty have not premised such findings on any special duty owed to the preferred stockholders. Rather, those cases have held that, absent a contractual provision, the directors owe the same fiduciary duties to the preferred stockholders as they owe to the common stockholders.[34]

In *HB Korenvaes Investments*,[35] Chancellor Allen considered whether fiduciary duties are owed to preferred stockholders, and concluded that the answer is contextual and requires an examination of the particular claim asserted by the preferred stockholders. The Chancellor reasoned as follows:

> In fact, it is often not analytically helpful to ask the global question whether (or to assert that) the board of directors does or does not owe fiduciary duties of loyalty to the holders of preferred stock. The

30 *Id.* at 855.

31 *See Equity-Linked*, 705 A.2d at 1057 (holding that, while "the board did, in effect, … try on behalf of the common to exploit the preferred," the holders of preferred stock were "open to this risk legally" as "a function of the terms of its security").

32 *Jedwab*, 509 A.2d at 594.

33 *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 387-89 (Del. Ch. 1999).

34 *See, e.g.*, *Jedwab*, 509 A.2d at 594 (finding that a preferred stockholder's claim that merger proceeds were unfairly allocated "implicate[d] fiduciary duties and ought not be evaluated wholly from the point of view of the contractual terms of the preferred stock designations"); *In re FLS Holdings, Inc. S'holders Litig.*, 1993 WL 104562, at *4 (Del. Ch. Apr. 2, 1993) (finding that "[i]n allocating the consideration of this merger, the directors, although they were elected by the common stock, owed fiduciary duties to both the preferred and common stockholders, and were obligated to treat the preferred fairly"), *aff'd sub nom. Sullivan Money Mgmt., Inc. v. FLS Holdings, Inc.*, 628 A.2d 84 (Del. 1993) (TABLE); *see also Fletcher*, 2010 WL 2173838, at *7.

35 *HB Korenvaes Invs., L.P. v. Marriott Corp.*, 1993 WL 205040, at *6 (Del. Ch. June 9, 1993).

> question (or the claim) may be too broad to be meaningful. In some instances (for example, when the question involves adequacy of disclosures to holders of preferred who have a right to vote) such a duty will exist. In others (for example, the declaration of a dividend designed to eliminate the preferred's right to vote) a duty to act for the good of the preferred does not. Thus, the question whether duties of loyalty are implicated by corporate action affecting preferred stock is a question that demands reference to the particularities of context to fashion a sound reply.[36]

In determining whether or not a particular claim asserted by a preferred stockholder is a contractual claim or a fiduciary claim, the Court of Chancery will therefore attempt to determine whether the claim or dispute "arises from rights and obligations created by contract or from 'a right or obligation that is not by virtue of a preference but is shared equally with the common.'"[37]

When the interests of the common stockholders and the preferred stockholders are in direct conflict, and the preferred stockholders have no express preferential rights that are implicated, the Court of Chancery has found that a board of directors, in the exercise of its discretionary judgment, may choose to favor the interests of the common stockholders over the interests of the preferred stockholders, so long as the board does not violate any fiduciary duty owed to the preferred stockholders.[38] As the Court explained in *In re Trados Inc. Shareholder Litigation*, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock ... to the interests created by the special rights, preferences, etc., of preferred stock."[39] Accordingly, when the interests of the common stockholders diverge from those of the preferred stockholders, a director may breach his or her fiduciary obligations unless the director favors the interests of the common stockholders over those of the preferred stockholders.[40]

Conflicting Interests in a Sale of the Company

In connection with a sale of control, a board of directors has a duty to seek to obtain the

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36 *Id.*

37 *Moore*, 1995 WL 662685, at *6. When preferred stockholders assert fiduciary claims that relate to obligations expressly addressed in the certificate of designations, the Court "will review those claims as breach of contract claims and the claims for breach of fiduciary duty will be dismissed as superfluous." *Fletcher*, 2010 WL 2173838, at *8 fn 57 (quoting *MCG Capital Corp.*, 2010 WL 1782271, at *15).

38 *See Equity-Linked*, 705 A.2d 1040.

39 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009) (quoting *Equity-Linked*, 705 A.2d at 1042).

40 *Id.* (citing *Blackmore Partners, L.P. v. Link Energy, LLC*, 864 A.2d 80, 85-86 (Del. Ch. 2004)). In transactions that require the approval of preferred stockholders, where the preferred seek to negotiate certain benefits in exchange for such approval, if a better transaction becomes available that favors the interests of the common stockholders, and does not interfere with the rights of the preferred, the board may therefore be required to take a position directly hostile to the interests of such preferred stockholders.

highest value reasonably attainable for the stockholders.[41] However, depending upon the way in which the transaction is structured, a corporation's common and preferred stockholders may have conflicting interests. For example, in *Equity Linked Investors, L.P. v. Adams*, Genta Incorporated, a Delaware corporation ("Genta"), was "on the lip of insolvency" and needed "to complete a financing transaction rapidly, or else face bankruptcy" within days.[42] In liquidation, Genta would have been worth less than the $30 million liquidation preference of the issued and outstanding shares of preferred stock of Genta. Thus, a natural tension developed between the common stockholders and the preferred stockholders.[43] The preferred stockholders sought "a means to cut their losses, which meant, in effect, liquidating Genta and distributing most or all of its assets to the preferred."[44] Importantly, however, the Court noted that "[t]he contractual rights of the preferred stock did not … give the holders the necessary legal power to force this course of action on [Genta]."[45]

Under those circumstances, the board of directors of Genta decided to engage in a two-step financing transaction with a lender. In the first step of the financing, the lender provided $3 million in financing to Genta in exchange for convertible notes, warrants, and an immediate right to designate a majority of the members of the Genta board. The second step of the financing involved a promise by the lender to arrange additional financing for Genta, and, if the lender was unsuccessful in locating at least $3.5 million of additional financing for Genta within six months, the lender would lose its right to designate a majority of Genta's board.

A preferred stockholder of Genta brought suit challenging the proposed transaction. The Court of Chancery held that the board's decision to favor the interests of the common stockholders over the interests of the preferred stockholders was not inconsistent with the board's duties under *Revlon*. The Court noted that "the facts out of which this dispute arises indisputably entail the imposition by the board of (or continuation of) economic risks upon the preferred stock which the holders of the preferred did not want," and that "this board action was taken for the benefit largely of the common stock."[46] The Court concluded, however, that "those facts do not constitute a breach of duty" because "[t]he facts of this case … do not involve any violation by the board of any special right or privilege of the … preferred stock, nor any residual right of the preferred as owner of equity."[47] Although "[w]hat the board did, in effect, was to try on behalf of the common to exploit the preferred – by imposing risks without proportionate opportunity for rewards," the Court found that the preferred stockholders were "open to this risk legally" as "a function of the

41 *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986).

42 *Equity-Linked*, 705 A.2d at 1041, 1051.

43 The common stockholders had an interest in seeing Genta continue to develop "promising technologies in research" in an effort to obtain "a large part of the 'upside' gain." The preferred stockholders, on the other hand, did not want Genta to put any of its current assets at risk, as "any loss that may eventuate will in effect fall, not on the common stock, but on the preferred stock." *Id.* at 1041.

44 *Id.*

45 *Id.*

46 *Id.* at 1042.

47 *Id.*

terms of its security."[48] As such, it was perfectly permissible for the Genta board to choose the course it had chosen. The Court explicitly noted that "*generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock … to the interests created by the special rights … of the preferred stock, where there is a conflict*."[49]

Importantly, however, the Court added that, while the Genta board determined, in its business judgment, to favor the interests of the common stockholders over the interests of the preferred stockholders, it is conceivable that, in a particular circumstance, a board of directors may reach a different business judgment and, consistent with its fiduciary duties in those circumstances, favor the interests of the preferred stockholders over the interests of the common stockholders.[50]

Conflicting Interests in the Allocation of Merger Consideration

A board of directors owes a duty of loyalty to its stockholders and, as such, must fairly distribute the proceeds of a merger or sale among all classes of stock.[51] However, "fair allocation" does not require equal distribution.[52] If procedural safeguards are in place during the decision-making process, the board generally will enjoy the protections of the business judgment rule.[53] When such safeguards are lacking, however, a court may specifically inquire into the fairness of the allocation and the transaction.[54]

For example, in *In re Trados*,[55] the plaintiff alleged that, in determining to pursue a merger and in approving a merger pursuant to which the preferred stockholders and management would receive all the merger consideration and the interests of the common stockholders would be cancelled, the Trados board members breached their duty of loyalty by improperly favoring the interests of the preferred stockholders.[56] The plaintiff, a holder of the Company's common stock, argued that four of seven directors were designated by private

48 *Id.* at 1057.

49 *Id.* at 1042 (emphasis added).

50 *Id.* (observing that "[w]hile the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so.") (citing *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991) (finding that, when a corporation is in the vicinity of insolvency, an independent board may consider the impact upon all corporate constituencies in exercising its good faith business judgment for the benefit of the corporation)); *Orban v. Field*, 1997 WL 153831 (Del. Ch. Apr. 1, 1997) (upholding a transaction in which the preferred stockholders received consideration but the common stockholders received nothing).

51 *Kennedy*, 741 A.2d at 387.

52 *Jedwab*, 509 A.2d at 596.

53 *Kennedy*, 741 A.2d at 387.

54 *See In re Trados*, 2009 WL 2225958, at *7; *In re FLS Holdings, Inc. S'holders Litig.*, 1993 WL 104562, at *5.

55 2009 WL 2225958 (Del. Ch. July 24, 2009).

56 *Id.* at *7.

equity funds holding preferred stock in the company. Thus, according to the plaintiff, a majority of the board members was interested and lacked independence when approving the merger and they improperly favored the interests of the preferred stockholders. Based upon plaintiff's allegations that a majority of the directors (i) had employment or ownership relationships with the preferred stockholders, and (ii) were dependent upon the preferred stockholders for their livelihood, the Court held that plaintiff sufficiently rebutted the presumption of the business judgment rule. The burden to demonstrate the entire fairness of the transaction therefore shifted to the director defendants, and the Court denied defendants' motion to dismiss.[57]

In *LC Capital Master Fund*,[58] the Court of Chancery rejected a breach of fiduciary duty claim brought by preferred stockholders arising from a preference because the board of directors complied with the contractual terms of the preference and owed no fiduciary duties with respect to such preference. In that case, Francisco Partners acquired QuadraMed and agreed to pay the preferred stockholders an amount equal to the price that the preferred stockholders would have received if they exercised their right to convert their shares of preferred stock to common stock.[59] Francisco Partners and QuadraMed calculated the per share price of preferred stock based upon the conversion formula set forth in the certificate of designations.[60] The preferred stockholders brought suit seeking to enjoin the merger alleging that the QuadraMed board breached its fiduciary duties of care and loyalty to the preferred stockholders by allocating to them "bottom line consideration."[61] In other words, the preferred stockholders claimed that the board of directors owed the preferred stockholders more than what their contractual preference required.[62]

In ruling in favor of QuadraMed's directors, the Court of Chancery denied the injunction on the grounds that the preferred stockholders could not demonstrate that the board likely breached its fiduciary duties to the preferred stockholders.[63] According to Vice Chancellor Strine, once a board of directors honors the preferred stockholders' contractual rights, "it

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57 *Cf. Hokanson v. Petty*, 2008 WL 5169633 (Del. Ch. Dec. 10, 2008) (dismissing common stockholders' claim that directors breached their fiduciary duties when, after an investor exercised an option to acquire the company, the board entered into a merger pursuant to which all merger consideration was allocated to preferred stockholders). *See also Oliver v. Boston Univ.*, 2006 WL 1064169, at *118-20 (Del. Ch. Apr. 14, 2006) (requiring defendant directors to demonstrate the entire fairness of the board's allocation of merger consideration between holders of common and preferred stock, based upon the court's finding that the board was comprised of individuals with ties to the preferred stock, and that the board treated negotiations pertaining to the allocation of merger consideration with a "surprising degree of informality").

58 990 A.2d 435, 438 (Del. Ch. 2010). The Court noted in its analysis the failure of the preferred stockholders to secure "drag-along" contract rights that would have enabled such stockholders to force a sale of the company, and eliminated the need for the four designated directors and two management directors to approve the transaction. *Id.* at *7 fn 41, 42.

59 *Id.* at 439.

60 *Id.*

61 *Id.* at 445.

62 *Id.* at 449.

63 *Id.* at 438.

need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common."[64] According to the conversion formula set forth in the QuadraMed certificate of designations, in the event of a merger, the preferred stockholders were entitled to receive the same consideration they would have received if they had converted their shares to common stock.[65] Since the board allocated to the preferred stockholders the amount calculated in accordance with the conversion formula, the Court of Chancery found that the board of directors complied with its contractual obligations to the preferred and owed nothing else with respect to the conversion preference.[66]

The Court explained, however, that although the board owed no fiduciary duties to the preferred stockholders with respect to the conversion preference, it still owed the preferred stockholders fiduciary duties relating to the merger. Specifically, the board owed the preferred stockholders fiduciary duties that the preferred stockholders shared with the common stockholders; namely, to take reasonable efforts to secure the highest price reasonably available for the company.[67] Since the preferred stockholders did not allege that the board failed to fulfill its fiduciary duty to obtain the highest value reasonably attainable, the Court did not explore the issue and denied plaintiff's motion seeking to enjoin the merger.[68]

In *LC Capital Master Fund*, the Court also concluded that common stock ownership by independent directors, rather than creating a conflict for such directors, generally should be viewed favorably by the Court since such ownership serves to align the interests of a board's independent directors with those of the Company's stockholders:

> To hold that independent directors are disabled from the protections of the business judgment rule when addressing a merger because they own common stock, and not the corporation's preferred stock, is not … something that should be done lightly …. Adhering to the rule of *Equity-*

64 *Id.* at 449.

65 *Id.*

66 *Id.* at 453-54. The Court suggested, however, that in a circumstance in which the terms of the preferred stock did not provide for a means to value the preferred stock in connection with a merger transaction, the board may need to act as a "gap-filling agency" and do its best to fairly reconcile the competing interests. *Id.* at 449. In that unique circumstance the board may be well-advised to employ a bargaining agent (e.g. a special committee) to act on behalf of the preferred.

67 *Id.* at 449 (noting that the duties shared between the preferred and common stockholders are articulated in *Revlon* and its progeny).

68 *Id.* at 438. Vice Chancellor Strine acknowledged that he was not presented with the "harder case" of preferred stockholders with an absolute right to large dividend payments, but no right to vote to approve a merger or to receive a liquidation preference, where financial analysis presented to the board suggested that the company could afford to pay such dividends to the preferred stockholders, but the board nonetheless failed to allocate additional merger consideration to the preferred. Noting that "this hypothetical case is harder" because the board is aware that the preferred stockholders would be entitled to dividends if the corporation remained a going concern, and the company was in a financial position to pay such dividends, the Vice Chancellor nonetheless concluded "Our law has not, to date, embraced the notion that Chancery should create economic value for preferred stockholders that they failed to secure at the bargaining table." *Id.* at 451 fn 56.

> *Linked Investors*, *Trados*, and other similar cases, which hold that it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred, avoids this policy dilemma.[69]

Noting that plaintiffs failed to present any evidence suggesting that the independent directors were "materially self-interested" as a result of their ownership of the common stock of the company, the Court determined that the special committee's allocation of merger consideration between holders of the common and preferred stock of the company was entitled to deferential business judgment review.[70]

The *Trados* and *LC Capital Master Fund* decisions reflect an ongoing effort by the Court of Chancery to limit the scope of possible fiduciary duty claims by preferred stockholders by requiring the parties instead to focus any such claims on the contractual nature of the preferred stockholders' investment. Recent jurisprudence also provides insight into the manner in which conflicts between common and preferred stockholders should be addressed, as well as the duties that directors owe to each constituency when addressing such conflicts. Specifically, in circumstances where a transaction triggers a preference of the preferred stock, the board must honor the preferred stockholders' contractual rights. In that circumstance, however, the board does not otherwise owe such stockholders fiduciary duties in connection with those rights.[71] In circumstances where the right claimed by the preferred stockholders is not a preference against the common stock, but a right shared equally with the common stock, the board owes the preferred stockholders the same fiduciary duties as common stockholders with respect to such shared rights.[72] Where the right claimed is not shared equally, and the board otherwise has complied with the express contractual rights of the preferred, the board may favor the interests of the common stockholders over the interests of the rights created by the terms of the preferred stock in circumstances in which the board exercises its discretionary judgment.[73]

In each of these cases, the Court's discomfort centered on the inherent conflict of a majority of the board and the failure to implement appropriate procedural protections to prevent the potential abuses that such a conflict may present. These decisions emphasize the value of insulating board procedures, such as establishing a special

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69 *LC Capital Master Fund*, 990 A.2d at 452 (Del. Ch. 2010).

70 *Id.* at 453. The Court in *In re Trados* stated with regard to such material self-interest that "the benefit received by the director and not shared with stockholders must be 'of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties ... without being influenced by her overriding personal interests.'" *In re Trados*, 2009 WL 2225958, at *6 (citations omitted).

71 *See LC Capital Master Fund*, 990 A.2d at 448-49; *see also HB Korenvaes*, 1993 WL 205040, at *7.

72 *See MCG Capital Corp.*, 2010 WL 1782271, at *15; *In re Trados*, 2009 WL 2225958, at *7.

73 *See LC Capital Master Fund*, 990 A.2d at 438; *Equity-Linked*, 705 A.2d at 1057.

committee comprised of independent directors,[74] securing a majority of the minority stockholder vote or, in the appropriate case, hiring an independent financial advisor to opine on the fairness of the allocation of merger consideration between a majority and minority interest, or permitting a representative of the minority interest to participate directly in negotiations concerning the allocation of merger consideration.[75] In the case of a private equity firm making an initial investment in a portfolio company, *In re Trados* further suggests that preferred stockholders should consider negotiating "drag-along" rights that would allow such stockholders to force through a sale of the company, particularly if the firm secures designated board representation as a condition of its investment.[76] Finally, the recent jurisprudence emphasizes the difficulty directors face if they are asked to support a sales transaction that favors the contractual interests of preferred stockholders over the residual interests of common stockholders.

Duty of Loyalty in Disclosures

A board of directors also owes all stockholders a duty to fairly and candidly disclose all facts material to a transaction.[77] When the directors publicly or directly issue communications about the corporation, whether or not the directors request action from the shareholders, the disclosure must be made with due care and loyalty.[78] A communication that is intentionally false or purposefully omits information constitutes a breach of the director's residual duties if the omission or falsehood is intended to mislead the stockholders.[79]

In *Kennedy*, two letters sent to a preferred stockholder failed to mention an impending sale of assets that would have rendered the preferred stockholder's shares valueless.[80] According to the Court, the omitted information would have significantly affected the plaintiff's exercise of its contractual rights.[81] Similarly, in *Eisenberg*, the Court found the board's disclosures misleading because they listed business and cost-saving rationales as the purposes for the corporation's self-tender offer, when the record showed that the true purpose was to take advantage of the unusually low price of the preferred stock.[82] While

74 *See In re Trados*, 2009 WL 2225958, at *2 (noting that the Trados board formed a mergers and acquisitions committee to explore a sale of the company which consisted of three directors designated by private equity investors holding preferred stock in the company).

75 *See In re FLS Holdings, Inc.*, 1993 WL 104562, at *5 (finding an *ex post* opinion issued by Salomon Brothers regarding the fairness of the allocation of the merger between common and preferred stockholders to be of limited utility, but describing such opinions as holding "some weight" in the appropriate factual context).

76 *See In re Trados*, 2009 WL 2225958, at *7 fn 38, fn 42.

77 *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1057 (Del. Ch. 1987).

78 *Kennedy*, 741 A.2d at 389.

79 *Id.*

80 *Id.* at 389-90.

81 *Id.*

82 *Eisenberg*, 537 A.2d at 1058-59.

there was nothing *per se* wrong with this true purpose, failing to candidly disclose that purpose violated the board's duty of loyalty because it omitted information material to the fairness of the tender offer.[83] In the context of a self-tender, the Court noted, the candor and accuracy of a board's disclosures are particularly important because such disclosures are not balanced with the disclosure of alternative positions.[84]

Conclusion

When considering an M&A transaction, a board must make a good faith business judgment as to whether the transaction is in the best interests of the company and its stockholders generally. In reaching such determination, however, the board should be cognizant of a number factors, including (i) the express contractual rights of the preferred stock as set forth in the charter or certificate of designation (for example, blocking votes, liquidation preferences, etc.), (ii) the company's contractual flexibility under the terms of the preferred stock to negate or overcome certain rights of the preferred stock (for example, considering an alternative transaction structure when that would create leverage in negotiations with the preferred stockholders), (iii) whether the board suffers from a conflict (for example, where a majority of the directors are elected by preferred stockholders and the proposed transaction would allocate some or all the merger consideration to the preferred stockholders, or where board seats are designated by holders of a company's preferred stock), and (iv) whether the board may have the right (or affirmative obligation) to take actions with respect to the nature of the sales process or the allocation of the merger consideration that favor the interests of common stockholders over those of preferred stockholders.

83 *Id.* at 1060.

84 *Id.* at 1057.