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Just How Preferred is Your Preferred?

Recent Delaware cases highlight the benefits of tuning up the terms of preferred equity investments to mitigate the risk of fiduciary duty claims.

Many financial investors structure their investments in private companies in the form of preferred stock. This instrument provides the investor with a preference as to dividends and liquidation proceeds over other equityholders, typically management or legacy stockholders, who hold common stock. A recent Delaware case, *ODN Holding*, highlights some potential fiduciary duty complications when enforcing those preferences in the context of an investment that has gone sideways or negative (i.e., when the portfolio company has limited funds available to satisfy those preferences — whether the payment of preferential dividends, the redemption of the preferred or the distribution of substantially all sale proceeds to the preferred).

In the *ODN* case, Vice Chancellor Laster refused to dismiss claims against the board of ODN that they breached their fiduciary duties to common stockholders by selling off pieces of ODN in anticipation of funding at least a portion of a mandatory redemption of the sponsor's preferred stock that vested after five years, because the asset sales shrunk the company significantly and impaired its ability to generate long-term value to the remaining stockholders.

In reaching this conclusion, the court emphasized that the rights of holders of preferred stock, like debt holders, are contractual even though preferred is a form of equity. By contrast, fiduciary duties are owed to the holders of "permanent capital" as residual claimants. In most cases, this will be the holders of the common stock, with fiduciary duties owed to the holders of preferred stock only to the extent their interests overlap with the interests of the common stock.

The court readily acknowledged the validity of the contractual obligation to the preferred holders to redeem their stock once the mandatory redemption right vested. However, VC Laster held that the board had a fiduciary duty to decide whether it was in the best interests of the common stock to commit an "efficient breach" of the company's obligation to the preferred and not take actions to fund the redemption because doing so diminished the longterm upside potential of the business (i.e., whether the portfolio company would be better off being subject to a damages claim from the holders of the preferred as compared to taking the company actions necessary to satisfy its obligations to the preferred). And because the sponsor was a controlling stockholder and therefore a majority of the directors were deemed not independent, the court evaluated the board's decision whether or not to breach the obligation to the preferred under the entire fairness standard (where the defendant must prove the fairness of process and outcome) as opposed to the more deferential business judgment standard (where the plaintiff has to prove that the board's action was not rational).

A similar outcome was reached in the *Trados* case in 2013 where the board sold a company that was "treading water" at a price that left no proceeds for the common stock after payment of the accrued obligations on the preferred stock. While the court in that case concluded — about eight years after the merger closed — that the sale price was in fact fair given the limited prospects of the company, it emphasized that the board should have separately evaluated whether the sale was in the best interest of the common stockholders even if rejecting the sale and continuing to struggle to try to improve the business made it much less likely that the preferred would ultimately be paid off.

Sponsors and other private investors will recognize that the fact patterns in these cases are not unique — not all investments pan out as expected and the preferences imbedded in the preferred stock investment are intended to provide pathways for the investor, who is usually the controlling stockholder, to salvage some portion of its investment (in fact, these sorts of preferred terms are often referred to as "downside protection"). With Delaware courts showing a willingness to critically assess board decisions to comply with binding contractual terms of preferred stock if doing so hurts the common stock, investors may want to consider including in the specific terms of the preferred stock automatic disincentives to fail to satisfy those obligations.

For example, if the accruing dividend rate on the preferred stock increases meaningfully if (1) a redemption obligation is not satisfied or (2) the company is not sold after a specified period of time, the board's decision whether to comply with the obligations under the preferred will by necessity include an assessment of further negative impact to the residual value of the common stock if the resulting economic penalties under the preferred are incurred. Investors can also consider including terms that, upon failure to satisfy obligations or passage of time, empower the holders of preferred stock to take actions in their capacity as stockholders rather than relying on the board whose actions are subject to fiduciary duty review. For example, robust drag-along rights empowering the controlling stockholder to sell the company (and force other stockholder to join in that sale) may alleviate some of the fiduciary duty considerations that would more directly impact a corresponding decision if it was reserved for the board.

Another structure-based option would be to make the preferred investment into a limited liability company (LLC) rather than a corporation, including by inserting a holding LLC above an operating corporation if a corporation is maintained for legacy or tax reasons. Under Delaware law, the members of an LLC can agree to limit or even eliminate default fiduciary duties applicable to its officers, directors and members, either generally or with respect to specific matters (like dividends, redemptions or sales).

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The benefits of structuring private investments as preferred equity continue to significantly outweigh the negatives. In light of recent Delaware cases, however, it is advisable to consider tuning up the terms of preferred investments to mitigate the risks of potential claims of breaches of fiduciary duties resulting from complying with the stated preferences.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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