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KIRKLANDPEN
Private Equity Newsletter

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Just How Preferred is Your Preferred?

PENpoints

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 equity-holders, 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, the Delaware court refused to dismiss claims against the ODN board 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, the court 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 long-term 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 embedded 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

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terms of preferred stock if doing so hurts the common stock, investors may want to consider including specific terms in the preferred stock with automatic disincentives to breach those obligations.

Possible incentives and terms include:

- increasing the accruing dividend rate on the preferred stock meaningfully if (1) a redemption obligation is not satisfied or (2) the company is not sold after a specified period of time, which will require the board, when deciding whether to comply with preferred stock terms, to 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;
- 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; and/or
- robust drag-along rights empowering the controlling stockholder to sell the company (and force other stockholders to join in that sale) that 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).

* * * *

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 *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

Recent U.S. Supreme Court Decision Underscores Importance of Treaty Planning to Protect Overseas Investments

The U.S. Supreme Court recently limited the circumstances under which a company can pursue remedies in U.S. courts as a result of a foreign government's expropriation of company assets. In that case, Venezuela seized oil rigs from the Venezuelan subsidiary of a U.S. oil company, but because the U.S. lacks a treaty with Venezuela providing for international investment protection, the Supreme Court held the U.S. company could not overcome Venezuelan sovereign immunity. This case underscores the importance of considering treaty protection in structuring investments in higher-risk countries. To learn more, see our recent *Alert.*

Trump Administration Launches Rare Probe of the National Security Impact of Steel Imports

The Trump Administration recently initiated a so-called "Section 232" investigation to assess the impact of steel imports on U.S. national security. Section 232 investigations are relatively rare: only two have been initiated since 1995, and in each case the Department of Commerce did not recommend any response by the President. This action reflects another step towards implementation of the Trump Administration's "America First" trade goals. To learn more, see our recent *Alert.*

PENnotes

Institute for Energy Law Mergers, Acquisitions & Divestitures Conference
Houston, TX, May 18-19, 2017

Kirkland is a sponsor of the Center for American and International Law - Institute for Energy Law's annual Mergers, Acquisitions & Divestitures Conference. Kirkland partner Rahul Vashi will be a panelist on "Lessons Learned from Big Deals," which will explore lessons from the last 12 months of major deal making, from antitrust to regulatory hold-ups to major deal collapses to large deals that made it through. Click here for more information.

IBA International Mergers & Acquisitions Conference
New York, NY, June 6-7, 2017

Kirkland is a sponsor of this year's event, which will bring together practitioners from around the globe to discuss the latest developments and hot topics in international M&A law, including globalization, nationalism and cross-border investment, governance, stewardship and activism, and private equity and leveraged finance today. Click here for more information.

2017 Open Source Seminar
Chicago, IL, June 7, 2017

Please join Kirkland and Black Duck Software for a seminar on current open source topics, which will include a refresher on open source general concepts and will explore open source best practices in various diligence contexts, including M&A. Data security issues raised by open source use and recent court cases highlighting offensive and defensive use of open source will also be discussed. The three-hour CLE program will be followed by a networking lunch. Click here for more information.

SuperReturn U.S. 2017
Boston, MA, June 12-15, 2017

SuperReturn U.S. 2017 will explore the trends and drivers of private equity and venture capital in North America, and provide networking opportunities within the global private equity community. Kirkland partner Norm Champ will be a panelist at the event. Click here for more information.

SuperReturn Energy 2017
Boston, MA, June 12-13, 2017

SuperReturn Energy will deliver strategies for investing in global energy private equity and provide an opportunity to network with key figures in the industry, and to learn more about pockets of opportunity, where LPs are looking and how best to generate alpha and fundraise in today's tricky market. Kirkland partners Adam Larson and Rhett Van Syoc will be panelists. Click here for more information.

Kayo Women's Energy Investment Conference
Houston, TX, June 12-13, 2017

Kirkland is a sponsor of the third annual Kayo Women's Energy Investment Conference, which will cover topics including energy's female founders, the future of energy lending, energy technology, public company perspectives, E&P and M&A, metals and mining, midstream and alternative fuels. Kirkland partners Sarah Kirson and Mary Kogut will serve as panelists. Click here for more information.

Chicago Private Equity Summer Kickoff Party
Chicago, IL, June 22, 2017

Kirkland will host a cocktail reception at Revival Food Hall to celebrate private equity in Chicago and kick off the summer. Attendees are invited to sample cuisine from Chicago's acclaimed culinary scene, enjoy summer-inspired cocktails and entertainment, and have a chance to win a pair of front row Cubs tickets. For every attendee, Kirkland will donate to the Greater Chicago Food Depository. Click here for more information.

PLI Annual Private Equity Forum
New York, NY, July 10-11, 2017

This annual event is designed to provide an understanding of the business and legal issues related to private equity investment, including recent regulatory and enforcement developments, compliance programs and ethical issues. Kirkland partner Robert Blaustein will speak on "How to Market Private Equity Funds on a Global Basis." Click here for more information.

PLI Understanding the Securities Laws 2017
New York, NY, July 13-14, 2017
Chicago, IL, September 27-28, 2017

This program will provide an overview and discussion of the basic aspects of the U.S. federal securities laws by in-house and law firm practitioners as well as SEC staff. Emphasis will be placed on the interplay among various regulations, as well as legislative and regulatory changes in the wake of the election. Kirkland partner Aaron Schlaphoff will speak at the New York event, and partner Bradley Reed will be a panelist at the Chicago event. Click here for more information.

Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis' nearly 500 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 400 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last six years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2017 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2016, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2016*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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