

WARNING TO PREFERRED STOCK INVESTORS FROM DELAWARE COURTS:**The Board of Directors Must Favor Common Stock****Preferred Holders Just Get Their Contract Rights**

Can preferred stockholders stop a merger in which the preferred stock gets less than its liquidation preference, while the holders of common stock walk away with substantial consideration? The answer in one recent Delaware Chancery Court case, *LC Capital Master Fund*,¹ is NO! That case can be seen as a follow-up to last year's troubling *Trados* decision,² in which preferred stockholders were put on notice that out-of-the-money common stock should still be allocated some consideration in a merger.³

There are two clear messages from the Delaware Chancery Court regarding preferred stock investments:

- *In a conflict situation, a board of directors' duty is to the common stock.* “[I]t 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 of the [preferred stock].”⁴
- *The preferred stock is limited to its express contract rights.* Preferred stock investors should take care to ensure that their underlying documents are properly drafted, as the preferred stock is entitled to nothing more than what is in the governing documents.

The dispute in the *LC Capital* case centered on the allocation of the merger consideration in the sale of Quadramed Corporation between the common stock and the Series A Cumulative Mandatory Convertible Preferred Shares. The case turned on the absence of a provision often found in the certificate of designation that treats a merger the same as a liquidation, essentially allowing the holders of convertible preferred stock in a merger to elect either to receive their liquidation preference in cash or to exercise their conversion rights and share in the merger consideration with the common stock. That provision was not present in the Quadramed certificate of designation.

¹ *LC Capital Master Fund, Ltd. v. James*, CA No. 5214-VCS (Del. Ch. March 8, 2010).

² *In re Trados Incorporated Shareholder Litigation*, 2009 WL 2225958 (Del. Ch. July 24, 2009).

³ In *Trados* the Delaware Chancery Court refused to dismiss a breach of fiduciary duty action against directors brought by common stockholders for a merger in which the preferred stock was to receive less than its full liquidation preference and the common stock was being wiped out. While this does not mandate a payment to the common stockholders, that can be seen as the practical effect of the decision.

⁴ *LC Capital* citing *Trados*.

The Quadramed merger agreement provided that the preferred stockholders would get the “conversion value” of the preferred stock (even though a merger was not one of the circumstances in which the mandatory conversion feature of the preferred applied). That “conversion value” was less than the liquidation preference per share. As the Quadramed preferred stockholders did not have the typical certificate provision or voting rights in connection with the merger, they were left with the argument that the allocation of the merger consideration breached the fiduciary duty owed to them by the board of directors. The Delaware Court, however, found that all the Quadramed board of directors had to do was to honor the articulated rights of the preferred and “[t]o the extent the board does so, it need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common.”

Just as there is a dichotomy in the duty owed to preferred stockholders and common stockholders, there is a difference in how preferred stock ownership and common stock ownership by the members of a board of directors is treated. In *Trados*, the Delaware Chancery Court found that the holders of common stock had adequately pled that the directors of Trados were “interested directors” because of the directors’ relationships to the holders of preferred stock of Trados. Thus, the court did not extend the business judgment rule to protect the decision of the Trados board of directors to enter into a transaction in which the common stock was wiped out. In contrast, in *LC Capital*, the Court was “chary” of finding directors to be not independent (and thus not entitled to the business judgment rule) because they owned common stock and not preferred stock. Ultimately, however, the *LC Capital* Court rejected the interested director argument because even assuming that common stock ownership would taint independence, the plaintiff did not show that the amounts at stake would be material to the directors, who “could be as rich as Croesus or Jimmy Buffett.”⁵

While the decisions in *LC Capital* and *Trados* may be a function of the procedural setting, which favored the plaintiff, the implications for preferred stock investors are clear: **make sure that the Certificate of Designation is clear as to the rights of the preferred, because when a conflict with the common stock arises, unless the rights of the preferred stock are clearly defined, the board of directors will be forced to side with the common stock.** We at Willkie are ready to assist you in drafting documents for your new investments and to review your existing investments.

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If you have any questions regarding this matter, please contact William H. Gump (212) 278-8285 or Maurice M. Lefkort at (212) 728-8239 or the other Willkie attorneys with whom you regularly work.

⁵ Vice Chancellor Strine, who authored the opinion, is known for his dry sense of humor, and the substitution of a Coral Reefer for the Wizard of Omaha was no doubt intentional.

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