WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

DELAWARE CLARIFIES APPLICATION OF MANDATORY REDEMPTION RIGHTS

Delaware Court of Chancery Clarifies Legal Standard for Preferred Share Redemptions and Gives Deference to Board Determinations Reached in Good Faith

A recent decision rendered by the Delaware Court of Chancery clarifies that traditional preferred stock redemption rights may be difficult to enforce unless such rights include specific remedies beyond the payment of cash upon exercise. In *SV Investment Partners, LLC v. Thoughtworks, Inc.*,[1] the court held that a company's board of directors, even when presented with a mandatory redemption right of its preferred shareholders contained in its charter (or certificate of designations) and a balance sheet surplus, will nevertheless be provided with considerable deference if it determines that funds are not "legally available" to redeem the shares, a concept that differs materially from a mere calculation of "surplus" according to its statutory definition.

The underlying controversy in the case arose in connection with the terms of a preferred stock investment by SV Investment Partners, LLC ("SVIP") in Thoughtworks, Inc. ("Thoughtworks" or the "Company"), a national software consulting firm. In 2000, SVIP purchased over 94% of the Series A Preferred Stock of the Company, and, pursuant to the Company's charter, was granted the right to have its shares redeemed for cash "out of any funds legally available therefor" beginning five years after the issuance of the stock. After SVIP and the other preferred stockholders exercised their redemption rights demanding the redemption of the entirety of their shares, the Thoughtworks board of directors determined that despite the possible existence of a surplus, the Company could not redeem all of the shares, concluding that such a redemption would hinder the Company's capacity to continue as a going concern, trigger insolvency and jeopardize the long term health of the Company. Each successive quarter during the next several years, the Company's board of directors carefully reconsidered these issues and, at the time of the lawsuit, had redeemed just over $4 million of the preferred shares, which had an aggregate redemption price of $45 million.

SVIP, in arguing that Thoughtworks possessed the legally available funds to satisfy its redemption obligation, presented expert evidence indicating that the Company's surplus should be valued between $68 million and $157 million. Thoughtworks, however, pointed to its historically volatile and unpredictable cash flows to bolster its assertion that a redemption would endanger the Company's ability to pay its debts as they became due. Thoughtworks' certificate of incorporation included fairly typical language stating that the preferred shares could be redeemed only "out of any funds legally available therefor." The court's analysis focused on the meaning of "funds legally available" for the payment of the redemption amounts and the Thoughtworks board's processes and methodology in determining the Company's capacity to redeem the shares.

[1] *SV Investment Partners, LLC v. Thoughtworks, Inc.*, C.A. No. 2724, WL 2010 4547204, (Del. Ch. Nov. 10, 2010).

Section 160 of the Delaware General Corporation Law (the "DGCL"), which sets forth the standards for legally acceptable share redemptions, provides that a corporation may not redeem its own shares for cash "when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation."[2] It is long settled, under both Delaware statutory law and the relevant case law, that a redemption may only be made out of a corporation's surplus, defined by DGCL Section 154 as the "excess of net assets over the par value of the corporation's issued stock."[3] However, as the court emphasizes throughout its opinion, treating "surplus" as identical to "funds legally available" is a fallacy. The court states that "funds legally available" is a broader term that contemplates whether a company has or can readily access cash, and whether such cash could be distributed without running afoul of the DGCL and/or common law restrictions regarding insolvency, creditors' rights and the impairment of capital. In reaching its conclusion, the court pointed to DGCL Section 160, which refers only to "capital," and not surplus, as well as other statutes clarifying that a company can have a surplus, but still not possess available funds from which it can legally redeem shares. Furthermore, the court reasoned that the overwhelming authority of the common law confirms that a corporation "cannot purchase its own shares of stock when the purchase diminishes the ability of the company to pay its debts, or lessens the security of its creditors"[4] whether or not it has a statutory surplus. The decision made clear that even if the "funds legally available" language was not explicitly included in Thoughtworks' charter, such a limitation would nevertheless be implied by Delaware courts.

The court also gave considerable deference to the Thoughtworks board of directors in its evaluation of whether the preferred shares could legally be redeemed. Under Delaware law, the court opined, a plaintiff seeking to challenge a deliberate judgment by a board of directors with respect to whether funds are legally available must prove that a board (i) acted in bad faith, (ii) relied on unreliable methods and data or (iii) made a determination so far off the mark as to constitute actual or constructive fraud. The court highlighted the board's reconsideration of the issue for sixteen consecutive fiscal quarters following SVIP's redemption request, its consultation with financial and legal advisors on an ongoing basis and its active, albeit ultimately unsuccessful, pursuit of debt financing in order to raise the funds required to redeem the balance of the preferred shares. Refusing to engage in a "mini-appraisal," the court's decision instead focused on what was deemed a sufficiently careful and good-faith analysis performed by the board.

Given the considerable deference that the court has provided to corporate boards in connection with fulfilling redemption obligations, preferred investors must explore alternative means of preserving the practical effectiveness of their redemption rights. The *Thoughtworks* court highlighted several of the options available to investors to sidestep the practical limitations that accompany mandatory redemption rights. For example, the purchase of either debt with warrant coverage or convertible debt allows an investor to reap the upside benefits of equity while

[2] 8 *Del. C.* § 160(a)(1).
[3] *Klang v. Smith's Food & Drug Ctrs.*, 702 A.2d 150 (Del. 1997).
[4] *In re International Radiator Co.*, 92 A. 255 (Del. Ch. 1914).

providing for a right of repayment to the investor regardless of a company's financial condition or prospects (subject to laws regarding creditors' rights in the event of insolvency). In addition, and in anticipation of a company's inability to redeem preferred shares, an investor may seek "penalty provisions" when a redemption demand goes unsatisfied, such as rights to board control, controlling a sale process and/or additional shares of stock.

When, as in *Thoughtworks*, redemption rights prove practically ineffective, inclusion of these additional forms of protection becomes paramount to protecting a preferred stock investment.

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If you have any questions regarding this memorandum, please contact Gordon R. Caplan (212-728-8266, gcaplan@willkie.com), William H. Gump (212-728-8285, wgump@willkie.com), Jeffrey R. Poss (212-728-8536, jposs@willkie.com), Jared B. Nicholson (212-728-8103, jnicholson@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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