Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Preferred Stock — Not So Preferred After All

Law360, New York (August 18, 2011) -- Preferred stock is the security of choice for private equity and venture capital investors. Preferred stock, which is often convertible into common stock, provides certain rights to its holders, including, most often, the right to receive sale proceeds and dividends in preference to common stockholders and the right to consent to certain actions by the company that could be detrimental to its intrinsic worth. PE and venture capital investors require these special rights to help encourage them to invest in illiquid and highly speculative ventures that may take several years to pan out.

The notion of "preferred" in preferred stock, however, may be a bit of a misnomer as the Delaware courts continue to make clear that preferred stockholders should not expect to get the benefit of anything other than a literal reading of the words that specify the rights of their preferred shares. The recent decision rendered by the Delaware Court of Chancery in Fletcher International Ltd. v. ION Geophysical Corporation underscores that the court's strict-construction position does not waver even when the company purposefully and admittedly uses corporate gymnastics to maneuver around the preferred's express rights.

At issue in Fletcher was the sale of a subsidiary's stock by the parent company to a strategic partner as consummation of a joint venture without first obtaining the consent of the preferred stockholder. The company's preferred stock in the Fletcher case had the right to consent to any issuance of stock to a third party by any subsidiary of the company. In order to get around this express restriction the company instead had the subsidiary issue stock to the parent itself and then the parent company simply sold that stock to an unaffiliated third party, all without seeking the preferred stockholder's prior consent.

The preferred stockholder argued that the economic substance of the transaction as a whole mandated that its consent be obtained before any such sale of stock. But the Delaware court emphasized that it was the parent and not its subsidiary that transferred the shares, so economic substance aside, the disputed transaction fell outside the literal purview of the preferred's consent right. The Delaware court, in granting defendant's motion to dismiss, noted that purposeful circumvention of the rights of the preferred did not open the door for the preferred to get any more than what was explicitly drafted in the terms of the preferred stock.

The court even stated that the fact that the company purposefully structured a transaction for the express purpose of obviating a clear preferred-stockholder consent right, a maneuver that had the exact same effect as what was otherwise prohibited by the preferred-stockholder rights, was “immaterial” to the court’s analysis of the facts and the law.

The Fletcher decision, along with other recent Delaware cases challenging customary notions of preference of preferred stockholders, underscore that looking beyond the four corners of preferred-stockholder contracts is not in the courts’ playbook when interpreting the rights of the preferred. Company or investor intent does not matter; economic equivalence does not matter; fairness does not matter.

The ruling means that the only thing that matters with respect to preferred-stockholder rights is the exact words used to set forth those rights. The court, therefore, has essentially mandated that the only way to protect preferred-shareholder rights is to draft and implement more detailed and aggressive preferred-stock contract provisions.

Preferred stockholders will receive no benefit of the doubt from the Delaware courts. The Delaware courts see preferred stockholders as sophisticated parties more than able to protect themselves through their contract rights. But even in the most sophisticated of transactions, among the most sophisticated parties, there is typically a notion of reasonableness and good faith and fair dealing.

The Delaware courts, however, have signaled that preferred stock investors may well be held to a different standard such that their rights are limited entirely to the written word, and even if the companies they invest in use corporate maneuvers to circumvent those rights, the Delaware courts will not intervene.

--By Gordon R. Caplan and Samantha Palmer, Willkie Farr & Gallagher LLP

Gordon Caplan is a partner with Willkie in the firm's New York office and co-chairman of the firm’s private equity practice, specializing in technology-related corporate matters, private equity, leveraged buyouts, mergers and acquisitions, recapitalizations and venture capital. Samantha Palmer is a law clerk with the firm in the New York office.