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Separate and Unequal Treatment in M&A Deals?

Director Duties to Different Classes of Shareholders

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Are directors' duties to all shareholders the same?

Every director knows (or should know) that since the Delaware Supreme Court decision almost 25 years ago in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), a corporation's directors owe fiduciary duties to the shareholders to take reasonable efforts to obtain the highest value reasonably attainable in a sale of the company. While fulfilling this duty in and of itself imposes careful deliberation, additional challenges arise when the shareholders are composed of different classes that may be treated very differently in a business sale. In those circumstances, how does a board reconcile its fiduciary duties when determining when, how, and for what value a company is to be sold, and allocating the sale proceeds between the different shareholder classes?

Unlike most closely held businesses, many venture-backed and private equity-backed companies have multiple shareholder classes. In those companies, the venture capital and private equity funds will frequently make their investments in the form of preferred stock with liquidation preferences, dividend rights and other rights distinct from those of common stock held by company founders, management or other shareholders. Further, these funds typically have targeted periods of time by which they desire a "liquidity event" to occur though a company sale, recapitalization or initial public offering to allow the fund to exit their investment and distribute the proceeds to their own investors. Even though some, or all, of the common shareholders may possess similar time horizons for a liquidity event, they generally are not under the same institutional influences to cause a liquidity event.

"Life is uncertain. Eat dessert first." - Ernestine Ulmer

The current unsettled M&A environment may serve to exacerbate the potential conflicting interests of preferred and common shareholders. Clearly, the capital market challenges in the past two years have hindered the ability for funds to affect portfolio company exits. According to a report by Thompson Reuters and the National Venture Capital Association (Thompson Reuters Corporation, "Venture-Backed IPO Volume Continues to Increase in Q2 2010 While Acquisitions Hold Steady," July 1, 2010), the number of "liquidity events" for venture-backed companies through M&A transactions or IPOs dropped from 379 M&A deals and 86 IPOs in 2007 to 271 M&A deals and 12 IPOs in 2009.

After nearly a two year drought, recent IPO market resurgence and M&A activity upswing indicates there may be improvement in funds' ability to create liquidity events. The same Thompson Reuters report totaled 92 venture-backed M&A deals in Q2 2010—a 42% increase in deals compared to Q2 2009. Also, in Q2 2010, there were 17 IPOs of venture-backed companies—the most quarterly IPO activity for venture-backed companies since 2007. Yet, the cause for business and M&A activity optimism may be tempered in the minds of many given the threats of rising taxes, flat or potentially deflationary pricing, high unemployment, credit market concerns, and potential capital market volatility. Perhaps some funds will view the present to be the right time to affect M&A exits given these uncertainties, particularly for their more seasoned portfolio investments. In contrast, other owners of the same companies may have different views and instead desire to see further improvement in the business and capital markets before considering a business sale. The uncertainties in the M&A market, combined with the increased exit opportunities for funds, may set the stage for a greater propensity for discord among shareholder classes.

Guidance from recent Delaware cases

In part due to the number of corporations incorporated in Delaware, the Delaware courts have been the source of much guidance in reconciling directors' duties and shareholders' rights. While Delaware courts have grappled with the issues concerning duties to different classes of shareholders in M&A transactions in the past, two recent cases are particularly useful in illustrating both the circumstances creating conflict and establishing how a board should address those conflicts.

The Delaware Chancery Court decision in *In re Trados*, 2009 Del. Ch. LEXUS 128 (Del. Ch., July 24, 2009) addressed the 2005 sale of Trados Inc. for $60,000,000, in which the preferred shareholders received 87% of the purchase price, the company's executive officers received the balance under a bonus plan, and the common shareholders received nothing. The transaction was approved by a seven member board of which a majority were designated by, and affiliated with, the preferred shareholders. In the months before entering into the transaction, the company's financial position and business improved markedly. After the transaction, a former common shareholder sued the board for breach of fiduciary duty contending that the sale was undertaken at the behest of the preferred shareholders that desired a transaction that would trigger their large liquidation preferences and allow them to exit their investment. In pursuing the sale, plaintiff argued that the board favored the interests of the preferred shareholders at the expense of the common stockholders and without properly considering the effect of the transaction on the common stockholders. To support the claim, plaintiff argued that the company did not need to be sold at that time as it was well financed and experiencing improved performance.

In analyzing the claim, the Court noted that the "rights and preferences of preferred shareholders are contractual in nature" and that directors owe fiduciary duties to preferred shareholders as well as common shareholders when the right claimed by the preferred shareholders is not as a preference against the common stock but rather is a right shared equally with the common shareholders. Where this is not the case, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock…." Noting that the plaintiff alleged sufficient facts that the board designees of the preferred shareholders were interested in the decision to pursue the sale given their involvement with the preferred shareholders, the court refused to dismiss the claims that the board breached its fiduciary duties in its actions to pursue the sale.

It is important to note some limitations on the impact of the *In re Trados* decision. First, the decision was rendered at an early stage in the case in connection with a motion to dismiss. While the Court refused to dismiss the case, it did not actually determine that in fact the board had violated its duties, leaving that decision to another day. Moreover, in that case, the Court observed that the sale resulted in the worst possible outcome for the common shareholders as they received nothing for their shares, and accordingly, at minimum, they would have been no worse off had the sale not occurred. Further, the *In re Trados* decision has not been officially published which significantly reduces its precedential value. However, the decision does provide a good example of a situation in which director judgment may be second-guessed when the interests of different classes of shareholders conflict.

In another decision in *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010), the Chancery Court reaffirmed the principle that, in general, directors do not owe special fiduciary rights to preferred stockholders to expand their rights beyond the express contractual rights of the preferred stock. In that case, a preferred shareholder sued to enjoin a merger of QuadraMed Corporation with an acquirer because the consideration to be received by the preferred shareholders was based on a conversion formula determined as if the preferred shares were converted into common shares in the event of a merger. The preferred shareholder claimed that the board was obligated to consider the preferred stock's strong liquidation preference in the case of liquidation and certain non-mandatory dividend rights and therefore accord preferred shareholders a greater amount in connection with the transaction.

The Court refused to enjoin the transaction and held that, when the company's charter document did not afford the preferred shareholders with any right to vote on a merger or a right to the higher liquidation preference in a merger and instead contained express provisions regarding the treatment of the preferred stock in a merger, the board

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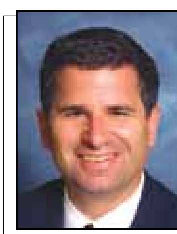

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can allocate the merger consideration in accordance with those "bottom line contractual rights." The Court further stated that, only when there is no contractual provision setting forth the preferred shareholders' treatment, is the board obligated to act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred. That was not the case in *LC Capital Master Fund*. The Court also relied on the fact that the QuadraMed board had complied with its *Revlon* duties by seeking the best value for the company, had considered whether the preferred shareholders should get more than the contractual bottom line, and on a thoughtful basis and with the advice of counsel, concluded that the preferred shareholders should not receive any additional amounts.

The Court, however, did indicate that this would have been a much harder case to decide in a case in which the preferred stock had an absolute right to annual dividend payments (rather than just having the right to have dividends accrue) and the corporation's discounted cash flow valuation would indicate that the corporation could pay those dividends. In that hypothetical case, it could be argued a different conclusion was warranted because the financial analysis undergirding the board's determination to proceed with a merger suggests that the corporation would have the financial capacity to pay to the dividends to the preferred and the company's charter required that the board do so if the corporation remained as a going concern. However, the court noted that was not the case with QuadraMed, raised the question of why a board should be obligated to continue the company as a going concern to maintain dividends if the preferred had not negotiated a right to block a sale, and observed that "our law has not, to date, embraced the notion that [the court] should create economic value for preferred shareholders that they failed to secure at the negotiating table."

Lessons learned

These cases provide the following valuable guidance to directors concerning their obligations with respect to allocating consideration in an M&A transaction among classes of shareholders:

- Boards of Directors, particularly those in which a majority of the board is designated or affiliated with preferred shareholders, need to be very careful in approving transactions in which there is a strong possibility of an argument by common shareholders that they would receive more if the company was not sold. In those cases, the board may want to consider various actions to ensure that the interests of the common shareholders have been properly taken into account, such as through the establishment of a separate board committee to represent the interests of the common, or providing for class voting by the common shareholders.
- The rights that the preferred shareholders negotiate in connection with their investment will be largely determinative of their rights in an M&A transaction, absent ambiguity in the instruments creating such shares or unusual circumstances.
- When the interests of different classes of shareholders may conflict, directors should engage in a deliberative process utilizing the advice of counsel and other professionals.