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Board of Director Obligations: Allocating Merger Consideration Between Preferred and Common Stock

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The rights of preferred versus common stock seem to be a perennial question, in part because the answer cannot always be discerned from the certificate of incorporation or certificate of designation. In the context of allocating merger consideration between preferred and common where the governing instrument is silent on this issue, a target's board of directors may be required to satisfy what the Delaware Court of Chancery recently described as a "gap-filling duty," pursuant to which directors would need to "fairly" allocate merger consideration between the competing classes of stock.[1] The nature of this duty and how one complies with it have yet to be fully explored by case law. But as with any director obligation, the exercise of this responsibility could invite challenge. In an effort to avoid this issue, corporations and their boards of directors would be well-advised to focus on incorporating explicit allocation terms in the instruments governing the rights of preferred.

In *LC Capital Master Fund, Ltd. v. James*, the Delaware Court of Chancery recently reaffirmed that under Delaware law the rights of preferred stock are primarily contractual in nature:

> **When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor. To the extent that the board does so, it need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common.[2]**

In adherence with this ruling, in the context of allocating merger consideration, "a

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board of directors that allocates consideration in a manner fully consistent with the bottom-line contractual rights of the preferred need not, as an ordinary matter, do more."[3] Thus, for example, where there is an objective contractual basis for allocating merger consideration between preferred and common, there is no obligation for the target's board of directors to establish a "negotiating agent" with the duty to advocate for the preferred stockholders in the allocation process. The *LC Capital* court acknowledged that earlier Delaware case law could be interpreted as requiring such an obligation.[4] It observed, however, that these earlier cases lacked an objective contractual basis for allocating merger consideration.

If there is no objective contractual basis for allocating merger consideration between preferred and common, then, according to *LC Capital*, a board of directors must "act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred." Put another way, the directors must act as the "backstop fiduciaries" and "figure out a fair way to fill the gap left by incomplete contracting."[5] Of course, the concept of directors owing fiduciary duties to preferred is not new to Delaware law. While the rights of preferred are indeed primarily contractual in nature, the Court of Chancery has held that "directors owe fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred is not to a preference as against the common stock but rather a right shared equally with the common."[6]

Nevertheless, while this concept is not new, the issue of how a board of directors satisfies a "gap-filling" duty is unsettled. For example, would a board of directors need to create two special committees (one representing the preferred and one representing the common) to steer the allocation process? Would each of these special committees need its own adviser? *LC Capital* suggests that this might be the case where there is no objective contractual basis to determine what constitutes a fair allocation.

The arguably indeterminate nature of this gap-filling obligation potentially invites challenge, opening the door to litigation, including claims that merger proceeds were not fairly allocated. From the perspective of the target corporation and its board of directors, an obvious question is how does one avoid wading into this thicket in the first instance? The answer seemingly is to specify clearly in the operative instrument the rights of the preferred in the merger context — specifically, the allocation of merger consideration to which the preferred is entitled. This, of course, may be easier said than done depending upon, for example, the particular negotiating dynamic between a potential investor and the corporation, or the need for a class vote to alter existing terms of preferred stock. But if the opportunity presents itself, addressing this issue unambiguously in the governing instrument may avoid later legal headaches. Such contractual specificity also may help to avoid valuation disputes in the appraisal context, if preferred seek to invoke any rights they may have under Delaware's appraisal statute following a cash-out merger.[7]

In short, Delaware law prefers to protect and enforce the contractual arrangements of parties, and corporations and directors can help obviate potential future disputes by addressing allocation issues upfront and having the instrument governing the rights of the preferred reflect clearly how merger consideration will be allocated among competing classes of stock.[8]

Apart from the above guidance, *LC Capital* also provides some reassurance to directors who sit on boards of companies that have common and preferred stock, but who personally own only common stock. The court resisted the idea that such directors also must own shares of preferred stock issued by their companies in order to secure their status as independent and disinterested directors. The court explained that if the directors pursue the best interests of the company and the common stockholders in a manner faithful to the contractual rights of the preferred, this effectively avoids the policy dilemma of whether directors should own a balanced portfolio of the company's various classes of stock.

NOTES

1. *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010).

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2. *Id.* at 448-49. Similarly, only this past April the Delaware Supreme Court reaffirmed that "with respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract." *Nemec v. Shrader*, C.A. Nos. 305 & 309, 2010 Del. LEXIS 150, at *22 n.33 (Del. Apr. 6, 2010) (quoting *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584 (Del. Ch. 1986)).
3. *LC Capital,* 990 A.2d at 438 (rejecting preferred stockholder's claim that consideration to be received by the preferred should exceed the "as if converted" value the preferred were contractually entitled to demand in the event of a merger). Similarly, in the appraisal context under 8 *Del. C.* § 262, where, following a cash-out merger, the Delaware Court of Chancery is tasked with determining the "fair value" of preferred stock, the Court of Chancery has held that "the most critical question…is whether the certificate of designation…contractually establishes the metric for valuing the preferred shares in the event of a merger"; if so, "the value of preferred stock is determined solely from the contract rights conferred upon it in the certificate of designation"; and therefore, "[w]hen determining the fair value of preferred stock…I must first look to the contract upon which the preferred stock's value is based." *See In re Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d 893, 900 (Del. Ch. 2009).
4. *See, e.g., In re FLS Holdings, Inc. S'holders Litig.*, C.A. No. 12623, 1993 WL 104562 (Del. Ch. Apr. 2, 1993); *Jedwab*, 509 A.2d 584.
5. *LC Capital*, 990 A.2d at 449, 447.
6. *In re Trados Inc. S'holder Litig.*, C.A. No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009) (citation and internal quotes omitted).
7. *In re Appraisal of Metromedia,* 971 A.2d at 902 n.25 ("In this litigation, of course, the preferred holders seek to extract additional value for their shares through the appraisal process even though it exceeds what the certificate defines as their right in the event of a merger or similar transaction. The rights of preferred holders, however, are clearly defined by the instrument (the certificate of designation) that created the security, and that instrument provides all the 'fair value' to which they are legally entitled in this appraisal.")
8. An acquirer of a corporation with preferred stock, as well as preferred stockholders of a target corporation, may have interests and strategies that differ from those of a target corporation whose board of directors is responsible for the allocation of merger consideration between preferred and common. The considerations of the acquirer and preferred stockholder are outside the scope of this article.

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