

# Private Equity 2011 - *Caveat Investor: What to Consider and What to Watch Out For When Investing Additional Capital Into A Portfolio Company*

By Jason R. Boyea and Christine Stanitski (this article will be published in the November-December 2011 Deal Lawyers Newsletter.)

In a distressed market, it can be difficult for a portfolio company to obtain additional debt or equity capital. In such times, or when capital is needed in short order, portfolio companies often turn to existing stockholders (whether private equity funds, venture capital or other investors) to provide the necessary funding.

These “follow-on financings” can be structured in several ways: (i) a follow-on financing at the same valuation as the previous round, (ii) a down-round financing, (iii) convertible promissory notes or promissory notes with warrant coverage, (iv) a bridge loan into a future round of financing, or (v) a more extensive restructuring. The exact form of the follow-on financing will depend on the specific facts and circumstances of the company, including the company’s financial situation and outlook, the status of the equity and debt markets, the constitution of the company’s shareholder base, the objectives and perspectives of the company’s investors and input from the company’s lenders.

At first blush, a follow-on financing with inside investors that does not involve a material capital restructuring can appear to be a very straightforward exercise. Typically, the investment documents from the prior financing are used as a template and revised to effect the additional financing. Very few third party consents are generally required and the lenders are usually fine with additional equity capital being raised. However, it comes as no

surprise that even the simplest follow-on financing will require board consent and will require the company’s directors to exercise, and fulfill, their fiduciary duties that run largely to the common stockholders of the company.<sup>1</sup> This is equally true of the director designees of the private equity investor who, when making decisions as a director, may not categorically prefer the interests of the preferred stockholders over the common stockholders.<sup>2</sup> This basic fiduciary duty analysis is well settled Delaware law.

What may come as a surprise is that recent case law, primarily Delaware, has increased the risks and pitfalls of follow-on private equity investments. This article will discuss these recent holdings and suggest “best practices tips” to minimize potential liability and litigation exposure. Moreover, an investor and its counsel should not merely have the goal of prevailing should a dispute with other shareholders arise, but should seek to avoid litigation and arbitration altogether. After all, a court holding that an investor and/or its director designees are not liable is not much to celebrate if the victory resulted in significant litigation expenses and poor publicity. The tips below should help to minimize the likelihood of these situations with better planning, structuring and, importantly from the perspective of recent Delaware case law – “process.”

***Caveat #1: Even with “Perfect” Process, a Controlling Stockholder May Not be able to Obtain the***

## ***Business Judgment Standard in a Follow-on Financing.***#

Under established Delaware law, decisions made by the board of directors of a Delaware corporation are generally afforded the presumption of the “business judgment rule” in which directors are presumed to have acted “on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”<sup>3</sup> As a result, courts will not second guess such decisions of a non-conflicted board unless the plaintiffs can demonstrate that the directors were grossly negligent by not employing a rational process that took into account all material information reasonably available.<sup>4</sup> Recently, in *In re Citigroup Inc. S’holder Derivative Litig.*, the Delaware Court of Chancery reaffirmed the application of the business judgment rule despite significant losses suffered by shareholders as a result of decisions of the board.<sup>5</sup> In *Citigroup*, the Court emphasized that the process is the key component of a breach of duty of care analysis not the result. According to the Court, “compliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed” and “the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.”<sup>6</sup> Further, the Court noted that bad faith can only be demonstrated if a director knowingly

violates a fiduciary duty in a conscious disregard for directors' duties.<sup>7</sup>

### **Entire Fairness and Follow-on Financings**

Unfortunately, the benefit of the business judgment rule may not be afforded in a follow-on financing. Regardless of the form it takes, follow-on financings, by their nature, are interested party transactions. Controlling stockholders may agree to lead a down round financing in which most of the preferred stockholders and some members of management participate. In such case, the board of directors may be comprised of a majority of directors designated by the controlling stockholder and without any, or just one, disinterested director. In such cases, the Delaware courts will generally apply an "entire fairness" standard of review.<sup>8</sup> Unlike the business judgment rule, the entire fairness test shifts the burden to the board to prove that a transaction is entirely "fair" to the corporation's stockholders with respect to price and process.

### **How Much Do You Have To Own to Be Controlling?**

Assessing whether an investing stockholder is a "controlling" stockholder is important when analyzing whether entire fairness will be applied. Decisions of a board in a transaction with a significant stockholder that is not controlling are likely to be afforded the protection of the business judgment standard, however, transactions with a "controlling stockholder" will likely be subject to entire fairness. In *In re Loral Space and Commc'ns*, the Delaware Court of Chancery applied an entire fairness standard of review when the board agreed to issue new equity to its 36% stockholder.<sup>9</sup> In addition to owning a significant percentage of the corporation's voting stock, the stockholder was affiliated with a majority of the board and had close personal ties to management. In applying entire fairness, the court determined that the stockholder was a "controlling" stockholder not just a "significant"

stockholder. *Loral* illustrates that a "controlling" stockholder can own less than 50% of the corporation's voting stock and the determination is fact specific. In practice, it is often the case that a follow-on financing will be led by a group of existing stockholders. The group may be controlling even if none of the stockholders rise to that level and entire fairness will apply.

### ***Caveat #2: Common Stockholders Have the Upper Hand with Respect to Fiduciary Duties.#***

In the much discussed 2009 *Trados* opinion, the Delaware Court of Chancery refused to dismiss a lawsuit alleging breach of fiduciary duty claims by the directors of Trados Inc. in approving a merger of Trados into SDL, plc.<sup>10</sup> The merger consideration was distributed to the preferred stockholders under the terms of Trados' certificate of incorporation and to management under a management incentive plan. The common stockholders received nothing in the merger and the total received by the preferred stockholders was less than the liquidation preference to which the preferred stock was entitled under the terms of the certificate of designation. Trados had a seven-member board; four members of which were designees of preferred stockholders and two members of which were due to receive payments under the management incentive plan. The preferred stockholder designees owned equity in, and/or were employed by, one or more preferred stockholders, and such designees were affiliated with entities owning a majority of the preferred stock of Trados. Plaintiffs argued that Trados' outlook was improving and the common stockholders would have been able to receive some consideration for their shares at some point in the future. The Court of Chancery determined that such an inference was reasonable under a motion to dismiss standard.<sup>11</sup> The *Trados* opinion highlights that preferred stockholders' protections are contractual in nature. In the absence of contractual protection, a board of directors owes fiduciary duties to preferred stockholders

only in circumstances in which the interests of the preferred stockholders are aligned with the interests of the common stockholders; if the interests of the common stockholders diverge from those of the preferred stockholders, the fiduciary duties run to the common stockholders.<sup>12</sup>

### **NVCA Reaction**

In response to *Trados*, the National Venture Capital Association ("NVCA") released an updated sample voting agreement and addendum that allows "electing holders" to cause a corporation to initiate a sale process. The provision requires the corporation to take a number of affirmative steps towards the sale of the company, including engaging a banker and lawyer and negotiating terms and conditions. The NVCA provision acknowledges that certain forms of exit transactions require board approval (i.e., merger or asset sale) and requires the corporation to call a meeting of the board if necessary. If the board does not ultimately approve the transaction, the electing holders may trigger a redemption obligation, causing the corporation to redeem all of the stock held by the electing holders at "a price equal to the amount of proceeds that would have been paid in respect of their shares of capital stock were the sale of the company consummated." As described by the NVCA, selling the company may be the only means by which the board is able to honor this contractual 'put' obligation. This type of provision can be particularly valuable in the event of a sale transaction in which the preferred stockholders do not get their full preference and the holders of common stock do not receive any proceeds.<sup>13</sup>

Despite the NVCA amendments, investors may not want to rely primarily on forced redemption provisions as their safety net. Statutory restrictions on the ability of a corporation to redeem its shares may prohibit a corporation from redeeming its shares at times when the investors most want the benefits of a negotiated redemption provision; i.e., when the corporation is in financial

trouble.<sup>14</sup> Delaware corporations are permitted to redeem their shares so long as the capital of the corporation is not impaired and so long as such redemption would not render the capital of the corporation impaired.<sup>15</sup> In a recent case, the Delaware Court of Chancery found that a corporation was not required to redeem the shares of its preferred stock despite a provision in the corporation's certificate of incorporation requiring such redemption *out of funds legally available*, and in so doing, the Court distinguished the meaning of the phrase "funds legally available" from "surplus." The Court found that "funds legally available" contemplates that the corporation has cash or other liquid assets that are accessible and ready for immediate use and that it is lawfully permitted to use such cash or assets for the designated purpose. Further, the Court included within the legal requirement that a Delaware corporation cannot be rendered insolvent by virtue of a redemption and that the redemption must not impair the corporation's ability to continue as a going concern. In other words, a Delaware corporation could have a "surplus" but not have "funds legally available" for payment of the redemption.<sup>16</sup> The redemption right in Thoughtworks is generally equivalent to the contractual put right in the NVCA Voting Amendment and highlights the limitations of relying on a forced redemption provision for downside protection.<sup>17</sup>

**Caveat #3: Follow-On Financings Can Trigger Revlon Duties.**

In *Loral*, the transaction resulted in the stockholder having the ability to block future actions of the company, including a potential sale of the company. As a result, in addition to the entire fairness standard of review, the Court applied the *Revlon* standard applicable to sales of corporate control. The *Revlon* standard requires boards in the context of a change of control to seek to obtain the highest stockholder value.<sup>18</sup>

The Delaware courts have applied the *Revlon* standard in transactions where a change of control "was an inevitable and foreseeable consequence" of a transaction that was not itself a change of control transaction. In an unreported decision, the Delaware Chancery Court applied a *Revlon* standard to the issuance of convertible bridge notes by DSL.net, Inc.<sup>19</sup> While DSL was in financial distress, the board agreed to enter into a financing transaction whereby the investor purchased convertible notes, representing on an as-converted basis more than 90% of the common stock of DSL. Six months after the closing of the financing, the investor elected to convert the notes and effect a short form merger thereby eliminating the minority stockholders. A follow-on financing is often structured as the purchase of convertible bridge notes or bridge notes with detachable warrants. Such a transaction may not have the immediate effect of a change of control but the dilution of economic and voting rights experienced by non-participating stockholders upon conversion or exercise and the resulting ability to direct a change of control may be an "inevitable and foreseeable consequence" of such transaction and in such circumstances, the board will be required to obtain the best available price for all stockholders.

**Caveat #4: Proper and Formal Process is as Important as the Result in Fiduciary Duty Law**

Recent Delaware case law appears to reveal a trend by the Vice Chancellors in requiring better process standards. This trend is certainly debatable and could be the thesis of a much longer, and much more academic, article. It is suffice to say for the purposes of this article that the following recent cases are a sample of recent decisions that point towards a Delaware Chancery Court trend towards more stringent process standards.

- *Trados* – this case is discussed throughout this article. The following process improvements could have resulted in a successful motion to dismiss the case: (i) a

special committee of the Board comprised of truly independent, disinterested directors (in this case, three of the four members of the committee were private equity investor designees), and (ii) maintaining professional communications (in this case, communications disclosed in the discovery process indicated that the directors were acting selfishly and not in the best interests of the stockholders).

- *Dubroff* – In a case of first impression, the Delaware Chancery Court denied a motion to dismiss on a breach of fiduciary duty of disclosure claim alleging insufficient disclosure with respect to a Section 228(e) notice (which is the notice required under Delaware law to be provided after written stockholder consent is obtained to those stockholders who did not consent in writing).<sup>20</sup>
- *PLATO Learning* – The Delaware Chancery Court granted an injunction due to omission of free cash flow analysis so that satisfactory disclosures could be provided to the stockholders.<sup>21</sup>
- *CNX Gas* – In this case, Vice Chancellor Laster adopted additional process standards to apply to a two-step merger (a tender offer followed by a reverse merger) such that the business judgment rule can only be obtained if a two step merger is (i) affirmatively recommended by a special committee of independent directors having the same authority as a board facing a third party transaction and (ii) subject to approval by a majority-of-the-minority stockholders.<sup>22</sup> The process requirements for two-step mergers remains an evolving, unsettled issue under Delaware case law.<sup>23</sup>

**Best Practices Tip #1: Treat the Process as Seriously as the Substance.**

When faced with an interested party transaction, such as an equity issuance in which existing stockholders with director designees participate, careful attention should be paid to the process. Normal “good practice” may not be enough to overcome the high burden of proving that the price of the transaction and the process followed were fair to the corporation and all of its stockholders, particularly the minority stockholders who may be diluted as a result of the transaction. There are steps that can be taken to, at best, have the court apply the business judgment standard of review, but, at minimum, to shift the burden from the defendants having to prove fairness to the plaintiffs having to prove unfairness.<sup>24</sup> In addition to normal good practice steps, boards should consider all or some of the following measures:

- *Include outside investors.* Having outside investors participate (and perhaps lead negotiations on behalf of all investors) can help establish that the price and process were fair.
- *Conduct a pre-signing market check.* A market check, supervised by independent directors, before deciding to have an existing stockholder infuse capital into the company, can ensure a fair price and evidences the integrity of the process, especially for a down-round financing. In addition, a follow-on financing which is in the form of a bridge note convertible into the next financing round at or near the pre-money valuation of the following round is arguably a built-in “market check,” depending, in part, on whether third party investors lead the following round of financing.
- *Obtain independent financial guidance.* Having an independent valuation done, particularly if there are no outside investors, can go a long way to help establish fairness.
- *Approval of disinterested directors.* Section 144 of the DGCL provides that an interested-party transaction is

not voidable solely because of the interested nature of the transaction if the interested director’s conflict is disclosed and the non-interested directors approve the transaction. As noted in this article, approval of disinterested directors can ensure judicial review under the business judgment rule or place the burden of proof on the plaintiffs under the entire fairness standard. Of course, this presumes that there are disinterested directors on the board. An investor should keep this in mind when negotiating the composition of the board. Management directors who don’t participate in the follow-on financing are not necessarily disinterested and their direct and indirect interests need to be disclosed and analyzed. For instance, if the follow-on financing includes a refresh of the option pool or the grant of other incentives to address management equity dilution, the management directors will most likely be deemed interested directors.

- *Approval of a majority of the minority of stockholders.* Approval of a majority of the minority of stockholders may shift the standard back to the business judgment rule but only if the material terms of the transaction and the interested nature of the transaction are fully disclosed to the disinterested stockholders. As noted above with respect to management directors, management stockholders may be interested stockholders due to indirect interests related to the follow-on financing and the participating investors.
- *Conduct a Rights Offering.* Giving all existing stockholders the opportunity to participate on a pro rata basis can help to mitigate any potential dilution that those most likely to challenge the transaction would otherwise suffer. A rights offering will need to comply with applicable federal and state securities laws. Typically, “non-accredited” stockholders (usually non-executive employee stockholders and former

employee stockholders who don’t meet the income or wealth test to be accredited stockholders) are excluded from a rights offering to preserve an exemption from registration under the Securities Act of 1933, as amended, and otherwise avoid enhanced disclosure requirements that are time consuming and expensive.

- *DGCL 102(b)(7).* Confirm that the corporation’s certificate of incorporation includes a §102(b)(7) waiver. While this will not change the standard of review, it does eliminate the personal liability of a director for monetary damages for breach of duty of care claims.
- *Establish a special committee of the board of directors consisting of at least two disinterested directors.* Delaware case law provides that the informed approval of an interested director transaction by disinterested directors coupled with proper board procedures may implicate the business judgment standard of review.<sup>25</sup> Moreover, two heads are better than one. The courts place more trust in a multi-member committee than a single member committee and having only one disinterested director may cause the standard of review to remain entire fairness.<sup>26</sup>
- *Provide Proper Disclosure.* When obtaining the consent of directors and stockholders, it is necessary to ensure that the material facts of the proposed transactions, and any related party interests, are properly disclosed and that the entirety of the disclosure is not misleading. This is especially important when obtaining written consent of the directors or stockholders in lieu of a meeting.<sup>27</sup>
- *Proper Records and Professional Conduct.* The deliberations of the Board should be sufficiently detailed in the minutes of meetings, including alternative options that were

explored and material market factors that were identified and discussed. Also, it is important that the Board, management and investors maintain a professional discourse and do not communicate in an unprofessional manner (such as in the *Trados* case). Slang terms such as “washout” or “cramdown” should be avoided.

- *D&O Insurance.* While not a process point, the Board should consider obtaining, or increasing, directors and officers liability insurance, with “Side A” coverage (insuring the directors directly for certain claims and losses where the corporation did not indemnify them).

Whether any or all of these measures are sufficient to shift the standard of review back to the business judgment rule is unclear,<sup>28</sup> however, it is clear that the more steps taken to eliminate the potentially coercive nature of a self dealing transaction, the more likely the transaction is to be fair both procedurally and substantively, to not be challenged and, if challenged, to be reviewed in the most favorable light possible for the directors and participants.

### **Best Practices Tip #2: Reevaluate Your Rights (for both New and Existing Investments)**

As mentioned above, follow-on financings are often structured using existing investor documents that were previously negotiated. While this may be the quickest and most cost effective means for infusing new capital into a portfolio company, it ignores an opportunity to reevaluate and strengthen existing contractual terms. This best practices tip applies equally to follow-on financings as well as investments in new companies – it is easy for investors (and their counsel) to get complacent with their “forms” even after material developments in applicable law and market practices prompt changes to the forms.

In light of the *Trados* opinion, Investors may want to seek additional

protections and rights surrounding possible, future exit events. Negotiating for the inclusion of a pre-negotiated buyout option (i.e., purchasing the other equity interests of the portfolio company), redemption rights, drag along rights or a sale process provision are just a few examples. In *Hokanson v. Petty*, the Delaware Court of Chancery dismissed a challenge that the board of directors of a Delaware corporation breached its fiduciary duties when it complied with a pre-negotiated buyout option and did not negotiate for a higher buyout price at the time of exercise of the buyout option.<sup>29</sup> The Court described the buyout option as the “cost of capital...at a time when.. it was facing financial ruin.” The Court added “[p]arties cannot repudiate their contracts simply because they wish they had gotten better terms.”<sup>30</sup> In *ThoughtWorks*, the Court of Chancery described the forced sale provision in *Hokanson* as an alternative way for investors to protect themselves and secure exit opportunities.<sup>31</sup> Of course, all stockholders may need to be a party to the agreement that includes the pre-negotiated buyout to ensure that such transaction can be affected.

### **Best Practices Tip #3: Make Sure the Contract Says What You Intend**

Since preferred stockholders protections are based in contract, a follow-on financing is a great time to make sure that your contractual provisions with respect to exit events are clear. In *LC Capital Master Fund, Ltd. v. James*<sup>32</sup>, a company agreed to be acquired by a private equity buyer through a merger in which the preferred stock was treated on an as converted basis. A merger was not included in the definition of a deemed liquidation event, which prevented the preferred stockholders from receiving their liquidation preference in preference to the holders of common stock. The certificate of incorporation provided that the preferred may (by converting) elect to receive the same consideration as the common; if the preferred did not convert to common it would receive the consideration determined by the board in

the merger agreement. The certificate of designation expressly provided that a merger does not trigger the preferred stock’s liquidation preference. In the merger, the preferred stockholders received less than their liquidation preference because the board approved a transaction that cashed out the preferred stockholders without allocating consideration to the preferred other than what they were to receive on an as converted to common stock basis. The preferred stockholders challenged the transaction as an unfair allocation and alleged that the board breached its duty of loyalty by treating the preferred on an as-converted basis notwithstanding its liquidation preference. The court did not enjoin the transaction and noted that so long as consideration is allocated to the preferred consistent with the contractual rights of the preferred, it may favor the common over the preferred.<sup>33</sup> If a merger was included as a deemed liquidation event, the preferred stock would have received its liquidation preference. Further, the certificate of incorporation should have been drafted to provide that the preferred stock was automatically entitled to the greater of (a) its liquidation preference and (b) what it would receive on an as converted basis.

In the current tight capital environment, investors have been faced with difficult investment decisions involving their existing portfolio companies. In some situations, they are effectively the last “life line” for these companies. The recent Delaware case law makes clear that the process followed is just as important as the decision made in these circumstances. In a sad twist of irony, should these companies become successful within the next three years<sup>34</sup> after the follow-on financing and realize a successful liquidity event, the shareholders who did not take the risk by infusing additional capital may try to bring a breach of fiduciary duty claim against the controlling shareholder and the board. The claim is then reviewed with the benefit of hindsight and any lapse in process will be magnified by the plaintiff’s counsel. These tips can mean the difference between being forced to

deal with such a dispute and avoiding the dispute altogether. Or it could mean the difference between being able to successfully seek a motion to dismiss under the business judgment rule and avoiding having to settle a claim on unfavorable terms due to the possibility of a full trial under the entire fairness standard. The additional ounce of caution being prescribed by recent case law with respect to contractual provisions and process will hopefully avoid expensive and protracted disputes and will allow an investor to properly focus on the important and difficult business decisions at hand.

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<sup>1</sup> See *In re Trados Inc. S'holder Litig.*, 2009 WL 2225958 (Del. Ch.) (discussed *infra*).

<sup>2</sup> See *Phillips v. Insituform of N. Am., Inc.*, 1987 WL 16285, at \*10 (Del. Ch. 1987) (stating that the "law demands of directors... fidelity to the corporation and all of its shareholders and does not recognize a special duty on the part of directors elected by a special class to the class electing them").

<sup>3</sup> See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

<sup>4</sup> See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872-873 (Del. 1985).

<sup>5</sup> See *In re Citigroup Inc. S'hlder Derivative Litig.*, 964 A.2d 106, 130 (Del. Ch. 2009) (the plaintiffs in the case alleged that the directors of Citigroup breached their fiduciary duties by making decisions that resulted in substantial losses in connection with the subprime mortgage market despite warnings about the declining market. Plaintiff shareholders essentially were attempting to hold the directors personally liable for what were, in hindsight, bad business decisions).

<sup>6</sup> *Id.* at 122.

<sup>7</sup> *Id.* (referencing *In re Caremark Int'l Inc. Derivative Litig.*, 698 A. 2d 959, 967-968 (Del. Ch. 1996)).

<sup>8</sup> See *Boyer v. Wilmington Materials, Inc.* 754 A.2d 881, 898-99 (Del. Ch. 1999). See also *In re Loral Space & Commc'ns* 2008 WL 4293781, at \*22 (Del. Ch. 2008) (applied entire fairness review when a special committee was not truly disinterested in the context of a derivative claim which alleged that a controlling (but not majority) stockholder's self dealing equity issuance was inequitable).

<sup>9</sup> *In re Loral*, *supra* note 8, at \*21 (Del. Ch. 2008) ("In determining whether a blockholder who has less than absolute voting control over the company is a controlling stockholder such that the entire fairness standard is invoked, the question is whether the blockholder, 'as a practical matter, possesses a combination of stock voting power and managerial authority that enables him to control the corporation, if he so wishes.'" (quoting *In re Cysive S'hlders Litig.*, 836 A.2d 531, 553 (Del. Ch 2003)).

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<sup>10</sup> See *In re Trados Inc. S'holder Litig.*, *supra* note 1 (Del. Ch. 2008).

<sup>11</sup> *Id.* The motion to dismiss standard is highly plaintiff favorable. The Delaware Court of Chancery may grant a motion to dismiss for failure to state a claim under Rule 12(b)(6) of the Federal Rules of Civil Procedure if the court can determine with reasonable certainty that the plaintiff would not be entitled to relief under any set of facts that could be reasonably inferred from the well-pleaded allegations in the complaint. See, e.g., *Malpiede v. Townson*, 780 A.2d 1075, 1082-83 (Del. 2001). The Court must accept the allegations of fact in the complaint as true and draw all reasonable inferences in favor of the plaintiffs. See, e.g., *In re Gen. Motors (Hughes) S'holder Litig.*, 897 A. 2d 162, 168 (Del. 2006).

<sup>12</sup> *In re Trados*, *supra* note 1 at \*7-9 (Del. Ch. 2008).

<sup>13</sup> See NATIONAL VENTURE CAPITAL ASSOCIATION, AMENDED AND RESTATED VOTING AGREEMENT (2011). Footnote 29 notes that the provision is intended to work in conjunction with the drag along provisions, and is not in lieu of them. It is not intended to give the electing holders additional substantive rights, but rather to assist them in effecting the transaction they have approved.

<sup>14</sup> Investors often seek penalty provisions to be triggered when a corporation is unable to meet redemption obligations. Penalty provisions include the ability to elect a majority of the corporation's board of directors and paying the redemption amount in the form of an interest bearing note.

<sup>15</sup> See Delaware General Corporation Law ("DGCL") § 160(a).

<sup>16</sup> See *SV Investment P'ners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 976 (Del. Ch. 2010). Investors ("SVIP") in ThoughtWorks negotiated a provision in the ThoughtWorks charter for mandatory redemption of such investors preferred stock after five years. The redemption was to be paid out of any funds legally available therefore. After making redemption demands SVIP initiated an action seeking declaratory judgment as to the meaning of the phrase "funds legally

available,” and essentially argued that “funds legally available” was equivalent to “surplus.”

<sup>17</sup> Investors intending to rely on redemption provisions for downside protection may want to consider alternative investment instruments such as convertible debt or debt with warrant coverage.

<sup>18</sup> See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

<sup>19</sup> See *Binks v. DSL.net, Inc., et al.* 2010 WL 1713629, at \*7 (Del. Ch. 2010).

<sup>20</sup> See *Dubroff v. Wren Holdings, LLC*, 2009 WL 1478697 (Del. Ch. 2009).

<sup>21</sup> See *Maric Capital Master Fund, Ltd., v. PLATO Learning, Inc.*, 11 A.3d 1175, 1179 (Del. Ch. 2010).

<sup>22</sup> See *In re CNX Gas Corporation S'holder Litig.*, 2010 WL 2291842, at \*13 (Del. Ch. 2010).

<sup>23</sup> See generally *Id.* See also *In re CNX Gas Corporation S'holder Litig.*, *infra* note 25 at \*13.

<sup>24</sup> In the context of mergers with controlling stockholders, Delaware courts have held that in certain circumstances the burden can be shifted to the plaintiffs to prove unfairness (for example, in a single step merger in which a transaction was approved by a fully functioning special committee of disinterested and independent directors or by a majority of the minority shareholders). See generally *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110 (Del. 1994). In two step freeze out mergers where the controlling stockholder conducts a tender offer for a certain percentage of shares at a set price followed by a short form merger, the Delaware courts have applied the business judgment rule if certain conditions have been met. See also *In re Pure Resources S'holder Litig.*, 808 A.2d 421 (Del. Ch. 2002). There exists a tension on the Delaware Court of Chancery regarding the disparate treatment of the two types of transactions. In articles and dicta of certain cases, certain chancellors have questioned the different treatment and have suggested a unified approach that would apply the business judgment rule in either context if certain conditions

have been met to render the transaction more like an arm's length merger where both disinterested directors and disinterested shareholders approve the transaction. This is yet to be addressed by the Delaware Supreme Court. See *In re CNX Gas Corporation S'holder Litig.*, 2010 WL 2291842, at \*13 (Del. Ch. 2010).

<sup>25</sup> See *Lynch Commc'n Sys.*, *supra* note 24 at 1115 (“[A]n approval of the transaction by an independent committee of directors...shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff.” See also, *Kohls v. Duthie*, 765 A.2d 1274, 1285 (Del. Ch. 2000) (“the existence and functioning of the committee will result in the application of the deferential business judgment standard of review to the transaction at issue”).

<sup>26</sup> A single member committee is required “like Caesar’s wife, to be above reproach.” *Gesoff v. IIC Industries*, 902 A.2d 1130, 1146 n.101 (Del. 2006) (quoting *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985)).

<sup>27</sup> See *Wren Holdings, LLC*, *supra* note 20.

<sup>28</sup> In *Kahn v. Tremont*, 694 A.2d 422, 429 (Del. 1997), the Delaware Court of Chancery appeared to hold that all self-dealing transactions are subject to entire fairness absent approval of a fully functioning special committee comprised of independent and disinterested directors. In *In re Loral Space & Commc'ns*, *supra* note 21, at 21-32, Vice Chancellor Strine avoided deciding whether an effective special committee would have shifted the burden, as per *Tremont*, or provided the business judgment rule’s protection:

“[f]urthermore, given the performance of the Special Committee, there is no need to consider some of the more intricate, interstitial standard of review issues that might have arisen had the special committee process been less desultory.” This dicta implies that there is a possibility that special committee approval could afford the business judgment rule’s protections.

<sup>29</sup> *Hokanson v. Petty*, 2008 WL 5169633 (Del. Ch. 2008). In 2003, Altiva Corporation secured financing from Exactech, Inc. in the form of preferred stock and convertible debt. The cost of such capital included a buyout option which (i) allowed Exactech to purchase all of Altiva’s outstanding securities during a specified time period, (ii) set the parameters for the purchase price and set a minimum value for the corporation, and (iii) allowed Exactech to determine the transaction form in its sole discretion. When Exactech exercised the buyout option in the form of a merger, the most senior preferred was paid in full, the two junior preferred series were paid in part and the common received nothing. *Id.* at \*1.

<sup>30</sup> *Id.* at \*6.

<sup>31</sup> *SV Investment P'ners*, *supra* note 16, at 991 (Del. Ch. 2010).

<sup>32</sup> *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010).

<sup>33</sup> *Id.* at 448-449.

<sup>34</sup> Three years is generally the statute of limitations for breach of fiduciary claims in Delaware. See 10 Del. C. §8106.