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Corporate Governance Group

Client Alert

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DELAWARE SUPREME COURT RE-VISITS MEANING OF “FUNDS LEGALLY AVAILABLE” FOR PREFERRED STOCK REDEMPTIONS

Upholds deference granted to board of directors in determining funds legally available for redemption, but declines to affirm bright line definition

In *SV Investment Partners, LLC v. ThoughtWorks, Inc.*,¹ the Delaware Supreme Court recently declined to evaluate the Court of Chancery’s attempt to provide a greater degree of certainty regarding whether a preferred stock issuer had “funds legally available” in the context of redemption rights.² However, the Supreme Court did affirm the Court of Chancery’s ruling in favor of the issuer on the basis that its board of directors was entitled to deference – absent bad faith or actual or constructive fraud – in determining the amount of funds available under the contractual terms governing preferred stock redemptions.

Background

ThoughtWorks, Inc. is an information technology professional services firm that designs business software applications and provides related consulting services. In 1999, as ThoughtWorks began to consider an initial public offering (“IPO”), it secured a \$26.6 million preferred stock investment from SV Investment Partners LLC (“SVIP”) to “enhance ... [ThoughtWorks’] credibility” as a potential issuer in the public markets.

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¹ 2011 WL 5547123 (Del. Supr. November 15, 2011).

² *SV Investment Partners, LLC v. ThoughtWorks, Inc.*, C.A. No. 2724-VCL (November 10, 2010). For a discussion of the Court of Chancery’s opinion, please see our Client Alert entitled “Delaware Court Sheds Light on Meaning of ‘Funds Legally Available’ for Preferred Stock Redemptions,” dated January 6, 2011.

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As a condition of its purchase, SVIP negotiated the right to require ThoughtWorks to redeem the preferred stock “for cash out of any funds legally available therefor” if the IPO was not completed within five years. In the event of a determination by the ThoughtWorks board that funds legally available” were not sufficient to redeem all the preferred stock when otherwise required, the redemption requirements were to be “continuous,” such that any funds thereafter becoming available had to be applied until the preferred stock was fully redeemed. The preferred stock terms further provided that the corporation’s assets were to be valued at “the highest amount permissible under applicable law” when determining the amount of funds legally available for redemption.

By late 2003, after the bursting of the “dot-com bubble,” it became clear that an IPO was no longer a realistic possibility. It became clearer still that ThoughtWorks would not have, and would not be able to raise, the cash necessary to meet its redemption obligation when it came due in April 2005. As a result, ThoughtWorks and SVIP discussed various possible resolutions and SVIP agreed to postpone the redemption date until July 5, 2005. In January 2005, ThoughtWorks engaged an investment banking firm to seek debt financing to redeem the preferred stock. When the results of this search proved disappointing, ThoughtWorks asked SVIP to accept \$12.8 million in full satisfaction of its redemption obligation. SVIP rejected this offer and instead demanded full payment, effective July 5, 2005, of the then aggregate redemption price of \$45 million.

In response, the ThoughtWorks board held a special meeting to analyze the extent to which funds were in fact legally available to honor SVIP’s demand. Based on outside legal and financial advice, and focusing on ThoughtWorks’ “ability to continue as a going concern,” the board determined that only \$500,000 was legally available for this purpose. The board carried out the same process for the following 16 quarters and paid a total of \$4.1 million to redeem a relatively small portion of the outstanding preferred stock.

Frustrated with this process, SVIP sought a declaratory judgment from the Court of Chancery as to the meaning of “funds legally available,” as well as a monetary judgment in the amount of the full redemption price. On March 25, 2010, while SVIP’s action was pending, ThoughtWorks secured a commitment that would have yielded \$23 million in debt financing, conditioned on SVIP settling for \$30 million in redemption of all of its preferred stock. SVIP rejected this proposal and the financing commitment expired.

Proceedings in the Court of Chancery

The Parties’ Contentions

SVIP argued that the term “funds legally available” should be equated with the term “surplus” as used in the Delaware General Corporation Law (“DGCL”). Section 160 of the DGCL authorizes a corporation to redeem its shares, *provided* that no corporation is permitted to

“(1) Purchase or redeem its own shares of capital stock for cash or other property when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation ...”

The Court of Chancery pointed out that Delaware courts have previously ruled that “[a] repurchase impairs capital if the funds used in the repurchase exceed the amount of the corporation’s ‘surplus’, defined by [DGCL] §154 to mean the excess of net assets over the par value of the corporation’s issued stock.” In this

connection, the courts at the time reasoned that “restrictions on redemptions are intended to protect creditors” by prohibiting impairment of “a permanent base of financing upon which creditors were presumed to rely when extending credit.”

Of course, creditors are no longer content to rely on the rather anachronistic concept of statutory surplus and, as a result, companies include the “funds legally available” limitation in preferred stock dividend and redemption terms. SVIP focused on these DGCL provisions in arguing that “a phrase such as funds legally available ... simply means funds that carry no legal obligation on their use. Under Delaware law, a corporation’s surplus is legally available for the redemption of its stock.” Further, SVIP produced expert testimony that ThoughtWorks in fact had surplus “in excess of the amount necessary to redeem all of the preferred stock.” ThoughtWorks, relying on the process that its board had followed for several years, disputed that it had the necessary funds.

The Court of Chancery’s Analysis

The Court of Chancery rejected SVIP’s approach, determining instead that while “funds legally available” is colloquially treated as if synonymous with ‘surplus,’ ... [t]he two concepts ... are not equivalent.” Based on its analysis of each word in the phrase, the Court of Chancery concluded that “[f]unds legally available” means something different” than simply having a surplus on a corporation’s books. Rather, “[i]t contemplates ‘funds’ (in the sense of cash) that are ‘available’ (in the sense of on hand or readily accessible through sales or borrowing) and can be deployed ‘legally’ for redemptions without violating Section 160 *or other statutory or common law restrictions*, including the requirement that the corporation continue as a going concern and not be rendered insolvent by the distribution.” [emphasis added].

Expanding on this interpretation, the Court of Chancery explained that a corporation may be considered “insolvent” under Delaware law “when its liabilities exceed its assets, or when it is unable to pay its debts as they come due.” Consequently, “a corporation can nominally have surplus from which redemptions theoretically could be made and yet be unable to pay its debts as they come due,” thereby precluding it from redeeming preferred stock. In fact, the Court of Chancery opined, even if the phrase “funds legally available” *had not* been included in the preferred stock terms, “a comparable limitation would be implied by law.”

Turning to the question whether the ThoughtWorks board properly determined the amount of funds legally available to redeem SVIP’s preferred stock, the Court of Chancery affirmed that “a dispute over that issue does not devolve into a mini-appraisal.” Rather, the preferred stockholder bears the burden of proving that a board of directors “acted in bad faith, relied on methods and data that were unreliable, or made a determination so far off the mark as to constitute actual or constructive fraud.” The Court of Chancery also noted that the valuation provision in the preferred stock terms did not eliminate the need for judgment on the part of the board, nor does it “require this Court to mark ThoughtWorks’ assets at the highest number a valuation expert can put on the Company while keeping a straight face.”

Finally, turning to the factual record, the Court of Chancery inferred that the ThoughtWorks board had “acted in the utmost good faith and relied on detailed analyses developed by well-qualified experts.” In short, the Court of Chancery found the board’s process to be “impeccable.” Moreover, the debt financing commitment produced by the board’s market test, conditioned as it was on SVIP accepting a discounted payment in full

redemption of its shares, was in the Court of Chancery ‘s opinion “the most credible evidence of the maximum funds legally available for a complete redemption of the Preferred Stock.” Accordingly, the Court of Chancery ruled in favor of the ThoughtWorks board’s incremental approach to redeeming SVIP’s preferred stock.

The Supreme Court’s Analysis

In a relatively terse opinion, the Supreme Court agreed with the standard of review adopted by the Court of Chancery, that is, “when a board decides on the amount of surplus available to make redemptions, its decision is entitled to deference absent a showing that the board: (1) acted in bad faith, (2) relied on unreliable methods and data, or (3) “made determinations so far off the mark as to constitute actual or constructive fraud.”

After briefly reviewing the record before it, the Supreme Court observed that the Court of Chancery had found the analysis of SVIP’s expert witness unconvincing inasmuch as “[i]t does not reflect ‘real economic value’ or bear any relationship to what ThoughtWorks might borrow or its creditors recover. It offers no assistance in determining” that the Board was not entitled to the deference otherwise accorded to decisions regarding the availability of funds to redeem stock. Because the Supreme Court saw “no reversible error by the Court of Chancery in finding that SVIP failed to meet its burden of proof,” it ruled that “the judgment of the Court of Chancery must be affirmed.”

Finally, and notably, because the Court of Chancery had determined that SVIP failed to prove its case even under its own definition of “legally available funds,” the Supreme Court decided that it “need not reach or even address the issue of whether SVIP’s definition [of legally available funds] is legally correct.” This exercise of judicial restraint obviously diminished the precedential impact of the Court of Chancery’s conclusion with respect to the meaning of the term.

Conclusion

The Supreme Court’s decision in *ThoughtWorks* bolsters the principle that Delaware courts generally will defer to decisions made by a board of directors in good faith regarding the legal availability of funds to make a mandatory redemption payment. However, the Supreme Court’s reluctance to evaluate the Court of Chancery’s explanation of the meaning of the term “funds legally available” leaves a degree of uncertainty that could have been avoided. As the law currently stands, it appears that Delaware courts will give issuer boards wide latitude in determining whether the issuer has the ability to redeem preferred stock. A preferred stock investor who requires a more precise definition of funds legally available, or who wishes to delineate the appropriate methodologies for determining when funds are available, would be wise to spell them out in the preferred stock’s governing instrument.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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