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Client Alert

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DELAWARE COURT SHEDS LIGHT ON MEANING OF “FUNDS LEGALLY AVAILABLE” FOR PREFERRED STOCK REDEMPTIONS

Gives deference to board of directors in determining funds legally available to cover cost of redeeming preferred stock

While preferred stock investors generally receive a preferred claim on a corporation's assets, their right to receive dividends and redemption payments typically is contractually restricted to “funds legally available” for that purpose. In *SV Investment Partners, LLC v. Thoughtworks, Inc.*,¹ the Delaware Court of Chancery recently rejected the argument advanced by a preferred stockholder that the terms “surplus” and “funds legally available” have equivalent meanings in the context of redemption rights. The Court determined that the two concepts, while often conflated, can in fact be quite different. Specifically, the Court found that a corporation can have statutory “surplus,” yet lack “legally available funds” due to other legal restrictions on its use of such surplus. Furthermore, the Court deferred to the judgment of the corporation's directors – acting in good faith after conducting a thorough investigation – that the amount of funds legally available did not permit it to honor in full its mandatory preferred stock redemption obligation.

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 IPO, it was able to secure a \$26.6 million preferred stock investment from SV Investment Partners LLC (“SVIP”) to “enhance ... [Thoughtworks'] credibility” as an issuer in the public markets.

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¹ C.A. No. 2724-VCL (November 10, 2010).

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 that funds “legally and otherwise available” at the time of redemption were not sufficient to redeem all the preferred stock, the redemption requirements were to be “continuous,” such that any funds thereafter becoming available were required 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 as to the meaning of “funds legally available,” as well as a judgment for 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.

The Parties’ Arguments

Section 160 of the Delaware General Corporation Law (“DGCL”) authorizes a corporation to redeem its shares, *provided* that no corporation shall:

“(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 ...”

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 designations. SVIP focused on the DGCL 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’s Analysis

The Court began its analysis by noting that a certificate of incorporation – including preferred stock terms contained therein – is a “contract among shareholders” to which the “general rules of contract interpretation apply.” As such, in resolving a dispute over the meaning of terms used in a certificate of incorporation, a “court should rely solely on the clear, literal meaning of the words contained in the contract.”

Against this backdrop, the Court stated 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 concluded that “‘[f]unds legally available’ means something different” than simply having a surplus on its 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]. 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.” Under this interpretation, therefore, “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 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 a consideration whether the Thoughtworks board properly determined the amount of funds legally available to redeem SVIP’s preferred stock, the Court affirmed that “a dispute over that issue does not devolve into a mini-appraisal.” Instead, 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 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.”

The Court inferred from the factual record that the Thoughtworks board “acted in the utmost good faith and relied on detailed analyses developed by well-qualified experts.” Most important, from the Court’s point of view, the board had “actively tested the market [for debt financing] to determine what level of ‘funds’ Thoughtworks could obtain.” In short, the Court found that the board’s process to be “impeccable.” And the debt financing commitment produced by this market test, conditioned as it was on SVIP accepting a discounted

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

Conclusion

The *Thoughtworks* decision is a helpful guide to the meaning of words that are often utilized in preferred stock designations but generally taken for granted. Typical of the approach long used by Delaware courts, the Court in *Thoughtworks* deferred to a thoughtful and diligent board process in resolving a claim brought by an unhappy shareholder. As the Vice Chancellor noted, “it is not the proper role of a court to rewrite or supply omitted provisions to a written agreement.” Rather, a “sophisticated” investor such as SVIP “easily could have protected its investment and avoided its current fate through any number of means ... [but] decided not to,” a choice that “was rational ... at the height of the dot-com mania from a technology firm ... which compared favorably with many issuers then embarking on over-subscribed and first-day-popping IPOs.”

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