

# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## Delaware Insider:

### Drafting a Mandatory Put Provision for Preferred Stock after *ThoughtWorks*

By [C. Stephen Bigler](#) and [Jennifer Veet Barrett](#)

An exit strategy frequently bargained for by venture and other equity investors is the right to require the corporation to redeem their stock under designated circumstances. Such “mandatory put” provisions are intended to create a contractual right in investors to have their stock redeemed and their investment returned. Since stock is equity, not debt, state corporation law limits the ability of the corporation to redeem its stock if its capital is impaired. This limitation is often incorporated into the terms of the put, which mandates that upon demand by the stockholder or some specified date or event, the corporation “shall redeem [the preferred stock] out of funds legally available therefor.”

Until the recent decision of the Delaware Court of Chancery in *SV Investment Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973 (Del. Ch. 2010), many practitioners believed the phrase “funds legally available therefor” was synonymous with statutory surplus calculated in accordance with applicable law. In *ThoughtWorks*, however, the Court of Chancery held that the phrase “funds legally available therefor” is not synonymous with “surplus” and instead requires that the corporation have liquid assets that are available for the redemption. The Delaware Supreme Court recently affirmed the Court of Chancery’s opinion, and in so doing, decided it need not address whether the phrase “funds legally available therefor” was synonymous with “surplus,” thus effectively letting the

Chancery Court’s holding on that issue stand. Investors should be aware of the interpretation given to the “funds legally available” phrase in the *ThoughtWorks* decision, and should consider alternatives to that language when drafting mandatory put provisions.

#### **Mandatory Put Provisions Pre-*ThoughtWorks***

Section 160 of the Delaware General Corporation Law permits a corporation to repurchase or redeem its shares, subject to certain restrictions. Generally, a corporation is prohibited from redeeming its shares if its capital is impaired or if the redemption would result in an impairment of the corporation’s capital. Delaware case law has interpreted this “capital impairment” test as requiring that the funds used for the redemption be paid out of the corporation’s surplus, which is generally defined by statute as the excess of net assets over the par value of the corporation’s issued stock. Therefore, in most circumstances, a Delaware corporation may redeem its shares to the extent of its statutory surplus. In calculating its surplus, the corporation determines the current fair market values of its net assets without regard to their liquidity.

Since preferred stock is otherwise a perpetual investment and often an illiquid investment, preferred stock investors often bargain for the right to exit their investment by putting their preferred stock

to the corporation for payment after a specified time and/or in connection with specified extraordinary events. Mandatory put provisions allow preferred stockholders the ability to exit their investment, at a time and price that is negotiated with the corporation at the time the preferred shares are purchased. Such exit provisions have received renewed interest in light of *In re Trados Inc. Shareholder Litigation*, 2009 WL 2225958 (Del. Ch. July 24, 2009), which refused to dismiss breach of fiduciary duty claims against preferred stockholders who approved a sale of the company where no proceeds were paid to the common stockholders.

The intent of a mandatory put provision is to create a legally enforceable obligation that the corporation redeem the preferred shares. These provisions are intended to convert the preferred stock into a debt-like obligation, entitling the holder of the preferred stock to obtain a judgment for the principal amount of the put upon default and to execute on the corporation’s assets to recover the amount of the judgment. Unlike debt, however, a corporation’s power to redeem its stock, including its preferred stock, is subordinate to the corporation’s obligations to its creditors. This limitation is recognized in state corporation statutes that provide that a corporation may not redeem its stock if the corporation’s capital is impaired. This statutory limitation is typically reflected in the terms of the mandatory put provision,

which specifies that the corporation shall redeem its preferred stock out of “funds legally available therefor” or some variant of that phrase.

Prior to the *ThoughtWorks* decision, it was generally believed by practitioners that “funds legally available therefor” meant the corporation had surplus. Indeed, the court in *ThoughtWorks* acknowledged that the phrase “‘funds legally available’ is colloquially treated as if synonymous with ‘surplus,’” and during a post-trial hearing recognized that “if you were going to go out and poll Delaware practitioners, when we hear ‘funds legally available,’ we immediately think surplus.”

### **ThoughtWorks**

In *ThoughtWorks*, SV Investment Partners, LLC, which owned more than 94 percent of the preferred stock of ThoughtWorks, Inc., sought to enforce a mandatory put provision in ThoughtWorks’ certificate of incorporation requiring ThoughtWorks to redeem shares of its preferred stock “for cash out of any funds legally available therefor.” In 2005, SV Investment Partners exercised their put rights under the ThoughtWorks certificate of incorporation. In response, ThoughtWorks’ board of directors, in consultation with its legal and financial advisors, evaluated ThoughtWorks’ finances to determine whether ThoughtWorks had surplus from which a redemption could be made, whether ThoughtWorks could readily obtain cash for the redemption (i.e., through borrowings), and whether the redemption would impair ThoughtWorks’ ability to continue as a going concern. The board of directors determined that ThoughtWorks only had \$500,000 of funds legally available and redeemed a portion of the preferred shares for that amount.

For the next 16 quarters, the board of directors repeated the same process to determine the extent to which funds were legally available for redemption and redeemed a total of \$4.1 million of its preferred stock. SV Investment Partners, however, disagreed with the board of directors’ piecemeal approach and argued that ThoughtWorks had sufficient surplus, as determined in accordance with sec-

tion 160 of the General Corporation Law, and therefore had funds legally available for the redemption and was obligated to honor the provision of its certificate of incorporation mandating the redemption of all of its preferred stock. SV Investment Partners filed suit seeking a declaratory judgment that the phrase “funds legally available” means statutory “surplus” and a monetary judgment for the lesser of the full amount of the redemption obligation and the full amount of ThoughtWorks’ “funds legally available.”

In evaluating SV Investment Partners’ claims, the court held that “the phrase ‘funds legally available’ is not equivalent to ‘surplus.’” Rather, “funds legally available” is a broader term that contemplates that the corporation has sources of cash that are accessible and ready for immediate use (either on hand or readily accessible through sales of assets or borrowing) and that it is lawfully permitted to use such sources of cash for the designated purpose. Thus, a Delaware corporation could have “funds” that are not “legally available” for payment in a redemption, or it could have “surplus” for a redemption but no “funds” that are “available.”

ThoughtWorks’ mandatory put provision required that the corporation revalue its assets “at the highest amount permissible under applicable law” for purposes of determining whether there were “funds legally available” for the redemption. The court, however, determined that the phrase “funds legally available” included not simply a requirement that the corporation have surplus but also a requirement that the payment not be a fraudulent conveyance by rendering the corporation unable to pay its debts as they come due or leaving it with insufficient funds to continue as a going concern. The court cited two early Delaware cases holding that a corporation cannot redeem its own stock when such a redemption would result in injury to or fraud upon the rights of the corporation’s creditors—*In re Int’l Radiator Co.*, 92 A. 255, 255 (Del. Ch. 1914) and *Farland v. Willis*, 1975 WL 1960, at \*6 (Del. Ch. Nov. 12, 1975).

In determining whether ThoughtWorks had “funds legally available,” the court

gave considerable deference to the determination made by the ThoughtWorks board of directors. The court found that the process employed by the ThoughtWorks board was “impeccable,” noting that the board relied on detailed analyses about the current state of ThoughtWorks, consulted with well-qualified financial and legal advisors to evaluate whether a redemption would impair ThoughtWorks’ ability to continue as a going concern, and tested the market to evaluate what level of funds ThoughtWorks could obtain for a redemption. When “directors have engaged deliberatively in the judgment-laden exercise of determining whether funds are legally available, a dispute over that issue does not devolve into a mini-appraisal.” The court found that SV Investment Partners had failed to demonstrate that, in determining whether funds are legally available, the board “acted in bad faith, relied on methods or data that were unreliable, or made a determination so far off the mark as to constitute actual or constructive fraud.” As a result, the court ultimately concluded that, regardless of whether ThoughtWorks had “surplus,” it did not have “funds legally available” to effect the redemption, and therefore was not obligated to redeem the preferred shares.

In the alternative, the court found that, even if it accepted SV Investment Partners’ contention that “funds legally available” means statutory surplus, it failed to meet its burden of proving that ThoughtWorks had sufficient statutory surplus to satisfy its redemption obligation because there was insufficient evidence to show that ThoughtWorks had, or was able to secure, “funds legally available” for the redemption.

The Chancery Court’s opinion was affirmed by the Delaware Supreme Court on November 15, 2011. The Supreme Court concluded that the record supported the Court of Chancery’s alternative holding that SV Investment Partners failed to carry their burden of proof to establish that ThoughtWorks had “funds legally available,” even under SV Investment Partners’ argument that the Court of Chancery’s interpretation of that phrase as being different from surplus was incorrect. Accordingly, the Supreme Court determined that it did not need to address the Court

of Chancery's distinction between "funds legally available" and statutory surplus and thus provided no further guidance on that topic.

### Drafting a Mandatory Put Provision Post-ThoughtWorks

The interpretation of the words "available funds" in the *ThoughtWorks* opinion as requiring not just that the corporation have surplus but also that it have ready access to the cash necessary to effect the redemption means that the form in which a corporation holds its assets, liquid or otherwise, could greatly affect the enforceability of a mandatory put obligation that is drafted subject to the availability of lawful funds. Thus, a corporation could possibly nullify a mandatory put by choosing to hold its assets in non-liquid form. The amount of effort required to borrow against or liquidate those assets to raise the cash to fund a redemption is not clear from the opinion. In *ThoughtWorks*, the court was impressed by the efforts made by ThoughtWorks to raise the necessary cash and deferred to their process. Moreover, the ability of the corporation to borrow or sell assets when the corporation is experiencing cash flow or other financial difficulties creates significant uncertainty. Thus, a mandatory redemption provision that is out of "funds legally available" may provide a much less certain exit than investors originally believed. The question becomes whether eliminating the phrase "funds legally available" from the mandatory put provision would yield a more certain result.

As an initial matter, it is unclear whether the *ThoughtWorks* ruling can be avoided by simply omitting the phrase "funds legally available." On the one hand, the court in *ThoughtWorks*, after acknowledging that the words "funds legally available" or "substantively identical variants customarily appear in charter provisions addressing dividends and redemptions," went on to note that "[w]ere those words omitted, a comparable limitation would be applied by law." Under this interpretation, any redemption likely will be subject to the requirement that, in addition to having surplus, the corporation have "funds" that are "available" such that the

redemption would not render the corporation unable to pay its bills as they come due or leave it with insufficient funds to conduct its business. However, in *Shifan v. Morgan Joseph Holdings, Inc.*, Strine, Chancellor, C.A. No. 6424-CS (Del. Ch. Jan. 13, 2012), an opinion issued after the Supreme Court's *ThoughtWorks* opinion, the Court of Chancery granted partial summary judgment finding that a mandatory put provision that did not expressly condition the company's redemption obligation on there being "funds legally available" created a legally enforceable obligation to redeem once triggered. While the Chancellor recognized that the mandatory redemption payment was subject to the requirement contained in section 160 of the General Corporation Law that "the company ha[s] legally available funds to make the redemption," the court did not appear to construe section 160 as requiring anything other than statutory surplus. In the briefing, the petitioner argued that the absence of the "out of funds legally available" language in the operative redemption obligation distinguished *ThoughtWorks*. The court's opinion does not reference the *ThoughtWorks* opinion, so whether the court found the absence of those words to be a distinguishing factor is not clear.

A drafting alternative that investors may consider to prevent a claimed lack of available funds due to a corporation's choice to hold the majority of its assets in non-liquid form is a mandatory put provision that is not directly linked to the corporation's cash or other readily available sources of cash. The court in *ThoughtWorks* found that the mandatory put provision at issue in that case directly linked "funds" to the concept of "cash" by providing that the redemption will be "for cash out of any funds legally available." Language that removes the concept of available funds, but still provides for a redemption paid in cash out of "surplus," or some similar concept, may provide little additional protection even though surplus is determined on the basis of the fair value of the corporation's assets and not available funds, since, as the *ThoughtWorks* court noted, a cash redemption cannot be

paid out of surplus, it can only be paid out of cash.

Another option is to eschew the "out of any funds legally available" language entirely and provide instead that the redemption is mandatory "unless prohibited by law." Since the statute prohibits a redemption only if capital is impaired, and capital impairment is determined based on the fair value of the corporation's assets, rather than solely on available funds, this formulation is less likely to be read by a court as including an available funds limitation. Nevertheless, in light of the suggestion in *ThoughtWorks* that an available funds limitation will be implied in circumstances where the redemption would be a fraudulent conveyance, even if not stated, it is not certain how much additional protection an "unless prohibited by law" formulation will provide.

In light of this uncertainty, investors should consider "penalty" provisions in the event the corporation does not honor a mandatory put for any reason, including the lack of available funds. The court in *ThoughtWorks* suggested possible penalty provisions that investors could seek in conjunction with a mandatory put provision, such as the right to elect a majority of the board until the redemption is paid, or drag along rights that would be triggered if the corporation is unable to redeem the preferred shares and would allow the preferred stockholders to sell their investment in the corporation and drag along the remaining stockholders in the sale. While both of these options provide additional protections to equity investors, they also come with some downsides that may prevent the investors from the forcing the redemption that they seek. For example, if the preferred stockholders are given the right to elect a majority of the corporation's board of directors who will serve until the redemption is paid in full, the preferred stockholder director-designees, like all directors, would owe fiduciary duties to the corporation and all of its stockholders. In accordance with those duties, the designated directors may be unable to take actions to use funds of the corporation to effect the redemption if other actions would be in the best interests

of the corporation and all of its stockholders. Drag along rights may be similarly ineffective in permitting investors to exit their investment in the corporation. Drag along rights, which are often included in a stockholders agreement, would only bind the parties to that agreement. While the investors who sign the stockholders agreement have the right to sell their shares, they do not have the right to drag along any stockholder who is not also a party to that agreement. Similarly, even if the drag along rights were provided for by amending the corporation's charter, it would only bind the holders of shares issued after or voted in favor of the amendment.

Perhaps more effective would be a penalty provision that would require the corporation to create a sinking fund if the corporation is unable to redeem its preferred stock pursuant to the mandatory put provision. Under the sinking fund provision, the corporation would be required to direct some or all of its free cash flow (or some similar cash requirement) into the sinking fund, which could only be used for the purpose of redeeming the preferred stock, until all of the preferred stock is redeemed. The application of the sinking fund provision is likely to encourage the corporation to redeem its preferred stock as quickly as possible to avoid the diversion of its cash into the sinking fund.

### Conclusion

The *ThoughtWorks* opinion is a stark reminder that preferred stock is equity, not debt. An equity investor's put rights are subordinate to the rights of the corporation's creditors, and put rights may provide little protection where the corporation is cash-strapped. Investors bargaining for mandatory put rights as an exit from an investment need to be aware of the limitations on put rights under Delaware law. Even where the corporation has surplus, such a put may not be enforceable in a circumstance where the redemption would be a fraudulent conveyance. Investors looking to have maximum leverage to enforce their put rights should not draft those rights as being out of "funds legally available," as such language may allow the corporation to, by choosing to hold

its assets in illiquid form or otherwise running a business with little liquidity, render funds "unavailable" for purposes of redemption and thus avoid the redemption obligation. A better alternative would be to require redemption "unless prohibited by law" without regard to the availability of funds. Attention should also be given to the remedies available in the event a redemption does not occur on the required date due to the lack of legally available funds.

*C. Stephen Bigler is a director and Jennifer Veet Barrett is an associate at Richards, Layton & Finger, P.A., in Wilmington, Delaware. The opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.*