PREFERRED STOCK REDEMPTIONS: LIMITING LIABILITY UNDER DGCL § 160

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INTRODUCTION

Preferred stock redemption rights can create serious problems for issuers and their boards of directors. At first glance, redemption rights seem relatively harmless. After all, redemption rights simply require an issuer to repurchase its preferred stock on pre-designated terms at a pre-designated time.[1] However, restrictions on redemption rights imposed by Delaware law can transform seemingly innocuous obligations into a ticking time bomb capable of detonation without warning and with disastrous results.[2] How can preferred stock redemption rights be characterized as a time bomb? What causes this bomb to go off? What steps can a company take to diffuse the bomb? This Article will answer these questions.

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[1] RICHARD A. BOOTH, FINANCING THE CORPORATION § 2:24 (2015) (noting that "[r]edemption is essentially a repurchase of shares."). However, the terms "redemption" and "repurchase" do not have identical meanings. The primary difference between a redemption and a repurchase is that a redemption involves the buyback of redeemable preferred stock, where the terms and buyback price were previously negotiated before the issuance of the preferred stock, while a repurchase involves a buyback where the price and terms were not previously negotiated. *See* SEALY & WORTHINGTON, CASES AND MATERIALS IN COMPANY LAW 522 (8th ed. 2007). In addition, these terms are defined differently in other areas of corporate law, such as taxation. *See* I.R.C. § 317(b) (1954).

[2] DEL. CODE ANN. tit. 8, § 160 (2010); DEL. CODE ANN. tit. 8, § 174 (1998); SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 987 (Del. Ch. 2010), *judgment entered*, (Del. Ch. 2011), *aff'd*, 37 A.3d 205 (Del. 2011) (noting common law restrictions).

Mandatory and discretionary redemption rights are often negotiated and included in the preferences of preferred stock.[3] Redemption rights provide issuers financial flexibility, allowing them to redeem preferred stock to secure financing on favorable terms,[4] take the firm public via an initial public offering ("IPO"),[5] or engage in other transactions.[6] Consequently, it is clear that redemption rights serve a legitimate and valuable business purpose for issuers.

Despite the benefits they provide, redemption rights have an inherent, critical shortcoming—an issuer's ability to redeem its preferred stock is restricted by Delaware law.[7] Delaware General Corporation Law (the "DGCL") § 160 and Delaware common law prohibit issuers from redeeming preferred stock under certain conditions, such as where the redemption would impair the capital of the issuer.[8] An issuer's failure to redeem its preferred stock when redemption is required can cause noncompliance with a redemption provision and thus negative

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[3] C. Stephen Bigler & Jennifer Veet Barrett, *Delaware Insider: Drafting A Mandatory Put Provision for Preferred Stock After ThoughtWorks*, BUS. L. TODAY, Jan. 2012, at 1 (noting that mandatory redemption provisions are "frequently bargained for").

[4] 3 TREATISE ON THE LAW OF CORPORATIONS § 18:13 (3d ed. 2015) ("Corporations frequently reserve the option to redeem preferred shares at a certain redemption price in order to facilitate future financing."); 11 FLETCHER CYC. CORP. § 5309 (2015) (describing redemption rights as a "valuable right in the event that market rates of interest fall so as to make refinancing attractive.").

[5] In general, issuers must dispose of their preferred shares before going public. *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 339 (2005). This is most often accomplished via conversion provisions. *Id.* However, mandatory redemption provisions have also been used for this purpose. *See* Clean Harbors Inc., Certificate of Incorporation (Ex. 3.70, Form S-4) (April 3, 2013), https://www.sec.gov/Archives/edgar/data/822818/000104746913003900/a2214091zex-3_70.htm (requiring the mandatory redemption of the preferred stock if a "Qualifying IPO" is made).

[6] Booth, *supra* note 1. Redemption can also benefit issuers by relieving them of obligations, such as dividend payments or coupon rates, associated with the preferred stock.

[7] DEL. CODE ANN. tit. 8, § 160 (2010); *ThoughtWorks, Inc.,* 7 A.3d at 987.

[8] DEL. CODE ANN. tit. 8, § 160 (2010); *see infra* notes 35–37.

consequences for the issuer.[9] Redemptions that are made illegally (*i.e.* in violation of DGCL § 160) also result in liability for both the issuer and its board of directors.[10] To avoid these problems, well-advised issuers must carefully draft the preferences of the preferred stock to ensure: (1) the probability that an issuer will be able to redeem its preferred stock when necessary is as high as possible, and (2) if redemption is restricted under Delaware law, the issuer's liability is limited. However, as this Article shows, issuers and their legal counsel have sometimes struggled to so effectively.[11]

In drafting redemption rights, issuers sometimes rely on disproven, ineffective drafting techniques that have been rendered ineffective by recent court decisions.[12] Litigation resulting from issuers' failure to effectuate required redemptions demonstrates that current drafting norms and techniques do not always protect issuers.[13] The problem, simply put, is: How may issuers draft redemption provisions in a way that maximizes the probability that they will be able to effectuate a redemption when necessary, while shielding themselves from liability where redemption is impossible?

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[9] An issuer's failure to make a required redemption can trigger: (1) liability and/or (2) other consequences, if the failure to make a redemption is a Voting Rights Triggering Event ("VRTE") or a penalty provision exists. *See ThoughtWorks, Inc.*, 7 A.3d at 991. Some penalty provisions require the redemption to be paid in the form of a one-year note to each unredeemed holder, while others allow the preferred shareholders to elect a majority of the issuer's board of directors until the redemption is paid. *Id.* (noting common "penalty provisions").

[10] DEL. CODE ANN. tit. 8, § 174 (1998) (imposing joint and several liability on an issuer's board of directors for making a redemption in violation of DGCL § 160).

[11] *See* TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015); Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *1 (Del. Ch. June 27, 2014).

[12] *ThoughtWorks, Inc.*, 7 A.3d at 976; C. Stephen Bigler & Jennifer Veet Barrett, *Delaware Insider: Drafting A Mandatory Put Provision for Preferred Stock After ThoughtWorks*, BUS. L. TODAY, January 2012, at 1, 3 (recommending that practitioners "consider alternatives to [funds legally available] when drafting mandatory put provisions.").

[13] *See* cases cited *supra* note 11.

To address this problem, this Article scrutinizes three recent decisions by the Delaware Chancery Court pertaining to restrictions on preferred stock redemptions: *SV Inv. Partners, LLC v. ThoughtWorks, Inc.*,[14] *TCV VI, L.P. v. TradingScreen Inc.*,[15] and *Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc.*[16] These cases offer insight into the way Delaware courts interpret and construe redemption provisions—lessons and insights that this Article evaluates and then condenses into a series of suggested practices for issuers.

This Article's analysis is confined to expansion-stage private to public companies, although the statements and analysis of law may be useful to other parties.[17] The rationale for this limitation is simple; smaller companies have less bargaining power when it comes to negotiating redemption rights and will likely be pressured into accepting terms proposed by a larger investor, such as a venture capitalist.[18] Consequently, small, private companies will be unable to enact many of the suggested practices that this Article recommends.[19] In addition, the

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[14] *ThoughtWorks, Inc.*, 7 A.3d at 976.

[15] TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015).

[16] Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *1 (Del. Ch. June 27, 2014).

[17] An expansion-stage company has a commercially available product or service that generates significant revenue growth, but may not be yet be profitable. Brett Church, *Developments in Banking and Financial Law: 2006-2007: IX. Venture Capital and Private Equity*, 26 ANN. REV. BANKING L. 76, n.45 (2007). This Article focuses on companies that range from growth stage privately held firms to fully developed publically traded corporations. Since the vast majority of public companies are Delaware corporations, the analysis focuses exclusively on Delaware law. Brian R. Cheffins, *Delaware and the Transformation of Corporate Governance*, 40 DEL. J. CORP. L. 1, 75 (2015) (noting that two-thirds of U.S. public companies are incorporated under Delaware corporate law).

[18] *See infra* note 19 ("Venture capital is often a financing source of 'last resort.' Companies that seek venture capital financing are generally left with no other alternatives for financing and are therefore in a weak bargaining position."). Venture capitalists may be unwilling to deviate from standard documents, such as NVCA forms, that do not adhere to the suggested practices of this Article.

[19] Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 TENN. L. REV. 79, 152 (1997).

analytical perspective is that of issuer's counsel. The interests of issuers and preferred stockholders may diverge in ways that affect the considerations and conclusions of this Article.

This Article proceeds in three parts. Part I introduces and describes redemption restrictions imposed by DGCL § 160 and Delaware common law. Specifically, Part I breaks down the mechanics of DGCL § 160 and explains, in a general manner, the analysis required by DGCL § 160, such as the calculation of a company's surplus and capital. In addition, Part I describes redemption restrictions imposed by Delaware common law and notes distinctions between the common law tests and the requirements of DGCL § 160. Finally, Part I highlights the potential consequences issuers face if they fail to redeem their preferred stock when redemption is required, including actions for breach of contract.

Next, Part II analyzes the methodology used by the Delaware Chancery Court in interpreting and construing redemption restrictions and provisions in the three cases cited *supra*—*ThoughtWorks*,[20] *TCV*,[21] and *Brevan*.[22] Part II explains the relevant facts and analysis used in each case and highlights "take away" points that practitioners should observe. These "take away" points show that changing contemporary drafting practices will benefit issuers.

Part III recommends that issuers implement the suggested practices listed in Part II. First and foremost, Part III encourages issuers to avoid problems associated with redemption restrictions altogether by excluding mandatory redemption provisions and put rights, a form of discretionary redemption trigged at the option of the holder, from the preferences of their preferred stock.[23] When such provisions must be

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[20] *ThoughtWorks, Inc.*, 7 A.3d at 976.

[21] TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015).

[22] Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *1 (Del. Ch. June 27, 2014).

[23] The Article will argue that the same benefits to a corporation that are accomplished via mandatory redemption provisions can be adequately

included, Part III advises that issuers include language that excuses redemption where redemption is prohibited by law. In addition, Part III suggests that issuers include a pro rata redemption clause to create flexibility in the event that redemption is restricted. Part III also explains that selecting a process for valuing corporate assets prior to issuing the preferred stock is advisable and may preclude challenges to an issuer's calculation of net assets and surplus.

Part III further advises issuer's counsel to exclude provisions that punish the issuer for failing to redeem its preferred stock (referenced herein as "negative drafting"), such as Voting Rights Triggering Events ("VRTE") and penalty provisions. Where negative drafting cannot be avoided, Part III recommends that issuers carefully draft penalty provisions or VRTE triggers so that these penalties will not apply when Delaware law prohibits redemption. Finally, Part III cautions issuers to beware of "specific action" clauses.

The Article ends with a summary conclusion explaining the practical value of this Article and suggesting certain practices. By implementing the suggested practices proposed in Part III, issuer's counsel can proactively reduce their clients' litigation risk[24] and, as a result, reduce costs.[25] By following this guidance, issuer's counsel can add value to transactions involving redemption provisions while at the same time reducing his or her client's risk.[26]

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addressed through the use of optional redemption provisions, allowing the preferred stock to be redeemed at the option of the company.

[24] *See ThoughtWorks, Inc.*, 7 A.3d at 976. This Article discourages the inclusion of mandatory redemption provisions and the use of option call rights. Avoiding these provisions can reduce a client's litigation risk. *See* Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *1 (Del. Ch. June 27, 2014).

[25] By reducing litigation risk, clients reduce costs. Avoiding default rights that non-redemption can trigger may also lower costs.

[26] By taking this Article's advice, counsel can maximize the probability that their clients will be able to redeem its preferred stock when redemption is required. This, in turn, prevents the triggering of penalty provisions or VRTE's, which can result in board disruption, fiscal consequences, or both. *See ThoughtWorks, Inc.*, 7 A.3d at 991 (discussing penalty provisions).

PART I: REDEMPTION RESTRICTIONS UNDER DGCL § 160 AND DELAWARE COMMON LAW

As previously noted, Delaware law restricts an issuer's ability to redeem its preferred stock.[27] These restrictions are embodied in the Delaware General Corporation Law, as well as Delaware common law.[28] This Part will explore the theory behind redemption restrictions, explain the way these redemption restrictions function, and outline the different mathematical calculations used to determine whether an issuer may legally redeem its stock.

A. The Theory of Redemption Restrictions

As discussed above, it is clear that redemption provisions serve a legitimate and valuable purpose for issuers by creating financial flexibility in their operations.[29] Why would the Delaware legislature and Delaware courts place restrictions on such a value-adding provision? Indeed, redemption restrictions under Delaware law are not designed to protect an issuer's shareholders, the issuer's board of directors, or even the issuing corporation itself; the parties that stand to benefit from redemption rights.[30] Restrictions on redemption rights exist to protect the creditors of Delaware corporations.[31]

Why is this protection necessary? The answer, in part, lies in the realities of corporate form. When a creditor contracts with a limited or general partnership in Delaware, the creditor may levy against the personal assets of the general partners if corporate assets are exhausted.[32]

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[27] DEL. CODE ANN. tit. 8, § 160 (2010).

[28] *ThoughtWorks, Inc.,* 7 A.3d at 987 (noting common law restrictions).

[29] *See supra* notes 4–6 and accompanying text.

[30] *ThoughtWorks, Inc.*, 7 A.3d at 982 ("Section 160's restrictions on redemptions are intended to protect creditors."); *see also* DOUGLAS M. BRANSON ET AL., BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY 266 (2d ed. 2012).

[31] *ThoughtWorks, Inc.*, 7 A.3d at 982; *see also* Bennett v. Propp, 187 A.2d 405 (Del. 1962).

[32] DEL. CODE ANN. tit. 6, § 17-403(b) (2015) (describing liability of a general partner in a limited partnership); DEL. CODE ANN. tit. 6, § 15-306 (2011) ("Except as otherwise provided in subsections (b) and (c) of this section, all

However, this remedy is not available to creditors who contract with corporations, since shareholders in a Delaware corporation typically have limited liability.[33] Without redemption restrictions, a corporation could theoretically distribute all of its assets, including those borrowed from creditors, to its shareholders, rendering the company insolvent and leaving creditors unable to recover.[34] Therefore, redemption restrictions, along with other restrictions such as those imposed on dividends by DGCL § 170, serve to protect creditors by prohibiting issuers from "purchas[ing] or redeem[ing] 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."[35]

Having discussed the theory and purpose behind redemption restrictions generally, this Part will now discuss the way redemption restrictions work. As noted previously, redemption restrictions have two sources: statutory law (DGCL § 160) and common law.[36] We begin our exploration by analyzing Delaware statutory law.

B. DGCL §160

Redemption restrictions have been a part of the Delaware General Corporation Law for over 100 years now.[37] As a general rule, under DGCL § 160, a company may not redeem or repurchase shares of its own capital stock when the capital of the corporation is either: (1) already impaired, or (2) would be impaired as a result of the repurchase

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partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.").

[33] DEL. CODE ANN. tit. 8 § 102(b)(6) (2015); BRANSON, *supra* note 30, at 266 (The corporate debtor's shareholder-owners have limited liability . . . .").

[34] *ThoughtWorks, Inc.*, 7 A.3d at 982 ("As a practical matter, the test operates roughly to prohibit distributions to stockholders that would render the company balance-sheet insolvent . . . .").

[35] DEL. CODE ANN. tit. 8, § 160 (2010); *see ThoughtWorks, Inc.,* 7 A.3d at 982.

[36] *See supra* note 35 and accompanying text.

[37] *ThoughtWorks, Inc.,* 7 A.3d at 991.

or redemption.[38] This restriction is sometimes referenced as the "balance sheet" or "capital impairment" limitation.[39] A repurchase is said to impair the capital of the issuer if the funds used in the repurchase exceed the amount of the issuer's "surplus."[40] Therefore, to determine whether a redemption is permitted under DGCL § 160, one must compare the cost of the redemption to the amount of the issuer's surplus.[41]

1. How Surplus is Calculated

The term "surplus" is defined in DGCL § 154, amidst convoluted language, to be "[t]he excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital . . . ."[42] In plain English, surplus is the excess of net assets over capital.[43] This is typically equivalent to a balance sheet insolvency test.[44] Therefore, to compute surplus, one must first calculate the capital and net assets of the corporation.

2. Calculation of Capital and Net Assets

The "capital," sometimes called "stated capital"[45] of a corporation is calculated differently depending on whether the issuer's stock has a par value. When the issuers stock has a par value, capital equals the par value of issuer's shares, increased by any further amount of consideration paid for the stock that the board of directors decides to

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[38] DEL. CODE ANN. tit. 8, § 160 (2010). The general rule is subject to some exceptions noted in the statute. *Id.*

[39] DEL. CODE ANN. tit. 8 § 102(b)(6) (2015); BRANSON, *supra* note 30, at 266. Outside of Delaware, some states may use an additional model called the "earned surplus" approach, which was incorporated in earlier versions of the MBCA. *Id.*

[40] *ThoughtWorks, Inc.,* 7 A.3d at 982.

[41] DEL. CODE ANN. tit. 8, § 160 (2010).

[42] DEL. CODE ANN. tit. 8, § 154 (2010).

[43] 18 C.J.S. CORPORATIONS § 176 (2016).

[44] *ThoughtWorks, Inc.,* 7 A.3d at 987 ("[A] corporation cannot be balance-sheet insolvent and meet the requirements of Section 160.").

[45] BRANSON, *supra* note 30, at 267.

allocate as capital.[46] Therefore, if an issuer had 10 million shares of common stock outstanding, par value $0.01 per share, and the issuer's board of directors decided not to allocate any further consideration from the shares to capital, than the issuer would have capital of $100,000.[47] However, when the issuer's stock has no par value, the entire amount received as consideration for the shares is capital, unless the board designates otherwise.[48] Therefore, if an issuer had 10 million shares of common stock outstanding, no par value, and received consideration of $1 per share, than the issuer would have capital of $10,000,000.

Defining the "net assets" of an issuer is a bit easier, yet, in practice, is more likely to lead to litigation due to disputes over the valuation of items.[49] In this context, "net assets" means the amount by which total assets exceed total liabilities."[50] However, problems arise when defendants and plaintiffs use different methodology or valuation principles when valuing an issuer's assets for the purposes of calculating

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46 DEL. CODE ANN. tit. 8, § 154 (2010); BRANSON, *supra* note 30, at 267. In accounting terms, the board can decide to allocate "paid in capital" to the corporation's capital. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *Determination of Amount of Capital and Surplus*, *in* § 5.22 DEL. LAW OF CORPORATIONS AND BUSINESS ORGARNIZATIONS (Supp. 2016). However, as a default rule, if the board does nothing, the capital is the par value of the shares. *Id.*

47 Note that in addition to allocating consideration paid for stock as "capital," an issuer's board of directors may also re-allocate part of its surplus as capital. DEL. CODE ANN. tit. 8, § 154 (2010) ("The capital of the corporation may be increased from time to time by resolution of the board of directors directing that a portion of the net assets of the corporation in excess of the amount so determined to be capital be transferred to the capital account.").

48 *See* BALOTTI & FINKELSTEIN, *supra* note 46 ("At the time no par shares are issued . . . the directors may determine what portion of the consideration applicable to the shares of any class or series shall be 'capital.' The portion so determined shall be the 'stated capital' attributable to these shares. If no such determination is made, all of the consideration shall be 'capital.'). Therefore, if the board does nothing, the entire amount of the consideration received in exchange for the non-par value shares is "capital," by default. *Id.*

49 Klang v. Smith's Food & Drug Centers, Inc., 702 A.2d 150, 152 (Del. 1997) (discussing dispute concerning methods of valuing a corporation's assets).

50 DEL. CODE ANN. tit. 8, § 154 (2010).

net assets.[51] Generally, issuers and their boards of directors are granted discretion in this regard.[52] The Delaware Supreme Court has stated:

> Directors have reasonable latitude to depart from the balance sheet to calculate surplus, so long as they evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values, and arrive at a determination of the surplus that is not so far off the mark as to constitute actual or constructive fraud.[53]

As a matter of best practice, the assets of a corporation should generally be measured at actual present value, even if the "book value" reflected on the issuer's formal balance sheet is different.[54] This idea was solidified by the seminal case of *Klang v. Smith's Food & Drug Centers, Inc.*, where the Delaware Supreme Court allowed a corporation to deviate from the "book" value of its assets and instead revalue its assets at present value.[55] The court remarked, "[a]llowing corporations to revalue assets and liabilities to reflect current realities complies with the statute and serves well the policies behind this statute."[56]

3. Sample Calculations

Having explained what "surplus," "capital," and "net assets" are and how to calculate them, one may verify their understanding of these

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[51] *Klang*, 702 A.2d at 154–55 (dispute over valuation of issuer's assets).

[52] *Id.* at 152.

[53] *Id.*

[54] James D. Honaker and Eric S. Klinger-Wilensky, *Dividends, Redemptions and Stock Purchases*, *Practical Law Practice Note 1-519-2507*, WESTLAW ("[A] board of directors should determine the existence of surplus in light of current value of its assets, which may differ from book value."); *Klang*, 702 A.2d at 154 ("It is unrealistic to hold that a corporation is bound by its balance sheets for purposes of determining compliance with Section 160.").

[55] *Id.*

[56] *Id.*

concepts by using this practice problem, working through four questions, and examining the model answer provided:[57]

Problem 1:

Issuer, Inc., a Delaware corporation ("Issuer"), has decided to redeem all of its outstanding Series A Preferred Stock (the "Series A"). The Series A was issued three years ago to a single investor, who received 10,000 shares in exchange for $100,000. The preferences of the Series A state that the Issuer has the option to redeem all or part of the Series A after two years for a redemption price of 1.5x the original purchase price. Pursuant to the Series A's Certificate of Designations, Issuer was paying dividends at a rate of 8% per annum and decided to redeem the Series A in order to avoid making these continuous payments. The Series A has no par value. Issuer has 10 million shares of common stock, par value $0.01 per share, outstanding. Issuer's board of directors has not elected to designate any of the additional consideration received for Issuer's common stock as capital. Finally, Issuer has assets of $20 million and liabilities of $5 million.

Question 1: What is Issuer's capital?

Issuer has a capital of $200,000. The non-par value Series A shares adds $100,000, the full consideration for the shares, to Issuer's capital account, following the general rule. Issuer's common stock adds an additional $100,000 in capital, since the par value of

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[57] This section is not meant necessarily for practitioners, but rather is intended to provide context for more uninformed readers who are not familiar with the process for calculating surplus under DGCL § 154. This sample hypothetical is completely fictional and any resemblance between the facts herein and actual issuers is unintentional and completely accidental. Note that, in practice, this analysis is expeditiously more difficult and counsel should seek the advice of accountants or other specialists concerning the valuation of assets, capital, and surplus.

each share ($0.01) times the number of outstanding shares (10 million) equals $100,000.

Question 2: What is Issuer's net assets?

The Issuer has net assets of $15 million. This is computed from subtracting the Issuer's total assets, brought to current value, of $20 million from Issuer's liabilities.

Question 3: What is Issuer's surplus?

Issuer has a surplus of $4.8 million. Surplus is the excess of net assets over capital. Issuer has net assets of $5 million and capital of $200,000. Therefore, Issuer's surplus is $4.8 million

Question 4: Can the Issuer legally redeem its Series A shares under DGCL § 160?

Yes. The total cost of redeeming the stock is 1.5 x the original purchase price ($100,000) of the Series A. Therefore, the total cost of redeeming the Series A, and subsequently the funds used, will be $150,000. DGCL § 160 permits an issuer to redeem its preferred shares, provided that the funds used in the repurchase to not exceed surplus. In this case, the funds used ($150,000) do no exceed the corporation's surplus ($4.8 million). Therefore, Issuer may legally redeem its Series A shares under DGCL § 160.

4. Summation

DGCL § 160 protects an issuer's creditors by prohibiting the redemption of the issuer's preferred stock, using funds that could otherwise be used to compensate creditors, when the capital of the issuer is impaired.[58] Determining whether a repurchase is permitted under Delaware law requires the calculation of the "surplus," "capital," and "net assets" of the corporation.[59] Calculating these figures, in practice, is

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[58] DEL. CODE ANN. tit. 8, § 154 (2010).

[59] DEL. CODE ANN. tit. 8, § 154 (2010).

extensively more tedious and difficult than the example presented here. Having discussed the application of redemption restrictions found in DGCL § 160, this Part will now analyze redemption restrictions recognized under Delaware common law.

C. Delaware Common Law Restrictions

In addition to restrictions imposed by DGCL § 160, Delaware common law also limits an issuer's ability to redeem its preferred stock.[60] A common law limitation on redemptions has been recognized in Delaware for over 100 years.[61] In application, Delaware common law *supplements*, rather than c*omplements*, the redemption restrictions imposed under DGCL § 160.[62] This means that Delaware common law operates as a restriction "independent of, and in addition to, the DGCL's explicit provisions."[63]

Delaware common law holds that an issuer "cannot purchase its own shares of stock when the purchase diminishes the ability of the company to pay its debts, or lessens the security of its creditors."[64] In this way, Delaware common law restricts redemptions on the basis of a cash flow insolvency test, while DGCL § 160 follows, essentially, a balance-sheet insolvency test.[65] Theoretically, it is possible that certain

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[60] TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015); SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 987 (Del. Ch. 2010), *judgment entered*, (Del. Ch. 2011), *aff'd*, 37 A.3d 205 (Del. 2011) (noting common law restrictions).

[61] *ThoughtWorks, Inc.*, 7 A.3d at 987 (noting that the Delaware Chancery Court had recognized the common law redemption restrictions since "at least 1914."); *In re* Int'l Radiator Co., 10 Del. Ch. 358, 359–60 (1914).

[62] *ThoughtWorks, Inc.*, 7 A.3d at 987 (noting that Delaware common law restrictions act "*in addition* to the strictures of Section 160.") (emphasis in original).

[63] *TCV VI, L.P.*, 2015 WL 1598045, at *9 ("[T]his Court has recognized common law restrictions on stock redemptions that are independent of, and in addition to, the DGCL's explicit provisions.").

[64] *ThoughtWorks, Inc.*, 7 A.3d at 987 (quoting *In re* Int'l Radiator Co., 10 Del. Ch. 358, 359–60 (1914)).

[65] *Id.*; Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 456 (1993)

redemptions would be permitted under DGCL § 160, using a balance-sheet solvency test, but would be restricted by Delaware common law, employing a cash flow insolvency test.[66] Therefore, Delaware common law restrictions on redemption supplement DGCL § 160's limitations and advance the general principle of creditor protection by insuring that issuers may not redeem stock while insolvent.[67] Issuers must analyze their situation under both tests when calculating whether they may legally redeem their securities.

D. The Consequences of Failing to Redeem Preferred Stock

What happens when an issuer fails to redeem its preferred stock when redemption is required? The result often depends on the language used in the preferences. Generally, failing to redeem stock when redemption is required can lead to: (1) lawsuits, (2) the triggering of penalty provisions, and (3) the triggering of a VRTE.

1. Consequences for Making a Redemption in Violation of DGCL § 160

To begin, this section focuses primarily on issuers who refuse to redeem their stock when redemption is required. If an issuer were to determine that a required redemption is prohibited under DGCL § 160, yet proceeds with the redemption anyway, then the issuer's board of directors would face immediate liability under DGCL § 174.[68] DGCL § 174 imposes joint and several liability on directors for the full amount paid in the redemption for any willful *or negligent* violations of DGCL § 160.[69] Therefore, issuers who believe that a required redemption would

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(noting that an inability to pay debts as they become due is a cash-flow insolvency test); James D. Honaker and Eric S. Klinger-Wilensky, *Dividends, Redemptions and Stock Purchases*, *Practical Law Practice Note 1-519-2507*, WESTLAW (noting that DGCL § 160 follows balance sheet insolvency test and Delaware common law uses a cash flow insolvency test).

[66] This situation implies that a corporation could theoretically have "surplus" but no cash and an inability to pay debts as they become due.

[67] *ThoughtWorks, Inc.*, 7 A.3d at 987.

[68] DEL. CODE ANN. tit. 8, § 174 (1998).

[69] *Id.*

cause the issuer to violate DGCL § 160 should refuse to proceed with the redemption.

2. Consequences for Failing to Redeem

Failing to effectuate a required redemption can result in numerous consequences for issuers. First, failing to redeem preferred stock may cause preferred shareholders to sue.[70] *ThoughtWorks*, *TCV*, and *Brevan* are three examples of cases where an issuer of preferred stock was sued in relation to a required redemption.[71] Regardless of whether the plaintiffs actually succeed, defending lawsuits such as these can be expensive and burdensome, particularly where the issuer is already experiencing financial trouble.[72] Lawsuits can seek declaratory judgment concerning the existence of a surplus, monetary judgment for the amount owed from the redemption, or assert breach of contract claims.[73] A creative litigator could state several different causes of action, including those not present in *ThoughtWorks*, *TCV*, or *Brevan*.[74] As detailed below, well-advised issuers can limit the effectiveness of these lawsuits by adding language to the preferences of their preferred stock that limit their liability.

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70 *See* cases cited *supra* notes 14–16 (citing lawsuits where the issuer was sued for not redeeming its preferred stock).

71 *Id.*

72 Lawsuit expense can be a particular problem in this context since issuers who are legally prohibited from redeeming their stock under DGCL § 160 or Delaware common law are more than likely insolvent. *See supra* note 64–65 and accompanying text. Furthermore, there is always the possibility that litigation resulting from an issuer's failure to redeem could deter future investors or creditors from providing capital to the issuer.

73 This is particularly troublesome, since preferred stock preferences are considered a part of the certificate of incorporation, and the certificate of incorporation is "viewed as a contract among shareholders . . . ." SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 983 (Del. Ch. 2010), *judgment entered*, (Del. Ch. 2011), *aff'd*, 37 A.3d 205 (Del. 2011); Matulich v. Aegis Commc'ns Grp., Inc., 942 A.2d 596, 600 (Del. 2008). Therefore, violating a redemption provision contained in a certificate of incorporation or certificate of designations of a series of preferred stock can be equated to breaching a contract.

74 *See* cases cited *supra* notes 14–16.

Second, an issuer's failure to redeem may result in penalties.[75] Preferred shareholders who have call rights (the ability to have the issuer redeem their shares at the option of the investor) may insist on the insertion of penalty provisions that would take effect if the preferred stock is not redeemed when the preferred shareholder calls for redemption.[76] For example, a penalty provision may provide that where the issuer is unable to effectuate a redemption, the issuer must pay interest on the outstanding amount required for the redemption.[77]

Finally, an issuer's failure to redeem may constitute a VRTE. In this context, a VRTE provides extraordinary voting rights to the unredeemed preferred stockholders.[78] For example, unredeemed holders of a class of stock may be allowed, under a VRTE provision, to elect a majority of issuer's board of directors until the redemption amount is paid in full.[79] The triggering of a VRTE and the consequences of a VRTE vary depending on the language of the provision. However, failing to redeem a series of preferred stock when redemption is required may result in the triggering of VRTE provisions, as well as board turnover that could follow.[80] Having explained, broadly, the possible consequences of an issuer's failure to redeem its preferred stock, we may now turn to Part II.

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[75] *See infra* note 134 and accompanying text (noting the presence of a penalty provision in *TCV*).

[76] *ThoughtWorks, Inc.*, 7 A.3d at 978–79.

[77] Penalty provisions like this example are often found in debt securities. Craig H. Averch et al., *The Right of Oversecured Creditors to Default Rates of Interest from A Debtor in Bankruptcy*, 47 BUS. LAW. 961, 964 (1992) (noting that "provisions for reasonable default rates of interest are enforceable.").

[78] *ThoughtWorks, Inc.*, 7 A.3d at 978–79 (providing the sample VRTE where the unredeemed preferred shareholders are allowed to elect a majority of the issuer's board until the redemption is effectuated); Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *1 (Del. Ch. June 27, 2014) (discussing VRTE).

[79] *ThoughtWorks, Inc.*, 7 A.3d at 978–79.

[80] *Brevan*, 2014 WL 2943570, at *7–8.

PART II: THOUGHTWORKS, TCV, & BREVAN

Having discussed the theory, mechanics, and impact of redemption restrictions in Part I, Part II analyzes the way these restrictions have been applied and interpreted in Delaware courts. Specifically, Part II will examine three opinions issued by the Delaware Chancery Court within the past six years: *ThoughtWorks*, *TCV*, and *Brevan*. While *ThoughtWorks* is the seminal case in this area, *TCV* and *Brevan* are unpublished opinions and do not represent final adjudications of the disputes at issue in the cases.[81] Nevertheless, the logic and process the Delaware Chancery Court employs in evaluating the issues presented in *TCV* and *Brevan* makes analysis of the decisions valuable.[82] Since *ThoughtWorks* provides the most authoritative discussion of redemption restrictions, the analysis begins there.

A. ThoughtWorks, Inc.

1. Facts

In *ThoughtWorks*, a group of affiliated investment funds and their advisor, SV Investment Partners (collectively "SVIP"), brought an action against the defendant, ThoughtWorks, Inc. ("ThoughtWorks"),[83] an information technology firm.[84] In 1999, six years after ThoughtWorks' incorporation, ThoughtWorks began seeking a $25 million private equity investment in their business.[85] SVIP received the offering memorandum

81 TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015); *Brevan*, 2014 WL 2943570, at *1. *TCV* involves the Delaware Chancery Court's decision concerning plaintiff's motion of judgment on the pleadings, while *Brevan* involves the court's decision concerning a motion to dismiss. *Id.*

82 *TCV* and *Brevan* also allow drafters to evaluate the way Delaware courts may handle issues that were not presented in *ThoughtWorks*. For example, *ThoughtWorks* does not mention VRTEs, but *Brevan* does.

83 *ThoughtWorks, Inc.*, 7 A.3d at 981.

84 *Id.* at 977.

85 *Id.* ThoughtWorks board believed that finding a major private investor would make the company more attractive to investors when it went public. *Id.*

circulated by ThoughtWorks, approached the company, and began negotiating the terms of an investment.[86]

In negotiations, SVIP and ThoughtWorks anticipated that ThoughtWorks would go public via an IPO within a year or two.[87] Despite this presumption, SVIP negotiated a mandatory redemption right, triggering five years after the issuance of SVIP's preferred stock, in case the anticipated IPO never materialized.[88] Ultimately, SVIP purchased 2,970,917 shares of ThoughtWorks' Series A preferred stock in exchange for an investment of $26.6 million.[89]

Two years after SVIP made their investment, the "dot com" bubble burst, scuttling ThoughtWorks' plans of making an IPO.[90] In 2003, with redemption looming, ThoughtWorks alerted SVIP that it would be unable to satisfy its redemption obligations.[91] In response, SVIP agreed to postpone the redemption until July 2005 to give ThoughtWorks time to seek outside financing for the redemption.[92] ThoughtWorks' attempts to secure outside financing failed and, on May 19-20, 2005, SVIP exercised their redemption right.[93]

On July 1, 2015, two days before the redemption was due, ThoughtWorks' board of directors convened to discuss SVIP's redemption demand.[94] ThoughtWorks' board concluded that it lacked the funds necessary to redeem SVIP's preferred stock and thus declined to make any redemption.[95] SVIP disagreed and filed a declaratory judgment action.[96] The Delaware Chancery Court held that

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[86] *Id.* at 978.

[87] *Id.*

[88] *Id.*

[89] *Id.*

[90] *Id.* at 979.

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] *Id.* at 979–80.

[96] *Id.* at 980.

ThoughtWorks had the legal obligation to redeem SVIP's preferred stock "to the extent funds are legally available therefor[e]."[97]

After this ruling, SVIP re-invoked their redemption rights.[98] ThoughtWorks' board met again to analyze whether ThoughtWorks had any "funds legally available" to use in the redemption.[99] The board determined that ThoughtWorks had $500,000 legally available to use in the redemption and thus redeemed $500,000 worth of SVIP's preferred stock.[100] ThoughtWorks' board continued this process of evaluation and redemption for four years, ultimately redeeming a total of $4.1 million worth of SVIP's preferred stock.[101] Despite this, in February 2007, SVIP filed an action against ThoughtWorks, seeking declaratory judgment as to the meaning of the phrase "funds legally available" and "a monetary judgment for the lesser of (i) the full amount of ThoughtWorks' redemption obligation and (ii) the full amount of ThoughtWorks' 'funds legally available.'"[102]

2. Issues

The Delaware Chancery Court, in applying DGCL § 160 to the SVIP's redemption claim, faced two major issues:

1. Whether the term "funds legally available" is synonymous with "surplus."[103]
2. What standard will Delaware courts use when reviewing a board of directors' calculation of surplus?[104]

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97 *Id.*

98 *Id.*

99 *Id.*

100 *Id.*

101 *Id.* at 981.

102 *Id.*

103 *Id.* at 983–84.

104 *Id.* at 988.

3. Analysis

The Delaware Chancery Court, in applying DGCL § 160 to SVIP's redemption demand, held that the phrase "funds legally available," as used in the preferences of ThoughtWorks' Series A preferred stock, is not synonymous with "surplus" as defined by DGCL § 154.[105] This holding shocked many, since drafting conventions at the time widely interpreted "funds legally available" and "surplus" as synonymous.[106] In coming to this conclusion, the Delaware Chancery Court reasoned that a corporation could lack "funds" and yet have the capacity to make redemptions or pay dividends out of its surplus using other corporate property.[107] "Funds legally available," according to the *ThoughtWorks* Court, means "'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 provisions."[108] Since SVIP's claims were predicated on the idea that "funds legally available" was synonymous with "surplus," SVIP's claims failed and the court refused to require ThoughtWorks to redeem additional shares of its preferred stock.[109]

In addition, the *ThoughtWorks* Court endorsed the Delaware Supreme Court's ruling in *Klang* that an issuer's board of directors is granted deference when it comes to valuing assets for the purpose of calculating "surplus."[110] Under *ThoughtWorks,* when an issuer's 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

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105 *Id.* at 983 ("The two concepts, however, are not equivalent.").

106 *Id.* (noting that the phrase "funds legally available" was "colloquially treated as if synonymous with 'surplus.'").

107 *Id.* at 984; *see* Alcott v. Hyman, 208 A.2d 501, 508 (Del. 1965).

108 *ThoughtWorks, Inc.*, 7 A.3d at 988.

109 *Id.*

110 *Id.* at 988; Klang v. Smith's Food & Drug Centers, Inc., 702 A.2d 150, 154–56 (Del. 1997).

determinations so far off the mark as to constitute actual or constructive fraud.[111]

4. Takeaways from ThoughtWorks.

Issuers can learn many lessons from *ThoughtWorks,* including:

1. **"Funds legally available" is not synonymous with "surplus."** After *ThoughtWorks,* "funds legally available" will no longer be construed as being synonymous with "surplus." [112] After *ThoughtWorks*, incorporating the phrase "funds legally available" in redemption provisions may be technically unnecessary, since *ThoughtWorks* states that where terms such as "funds legally available" are omitted, "a comparable limitation would be implied by law."[113]
2. **The use of mandatory redemption provisions and put rights should be avoided if possible.** If the redemption provision in *ThoughtWorks* functioned as a call right, a discretionary redemption at the option of the issuer, rather than a mandatory redemption or discretionary put right, then ThoughtWorks could have avoided litigation completely, since the company would have had no legal duty to repurchase its shares.
3. **Valuation Provisions will not overrule board discretion in valuing assets**. A valuation provision may require that an issuer value its assets at the highest amount possible under applicable law. However, as *ThoughtWorks* makes clear, a valuation

[111] *ThoughtWorks, Inc.*, 7 A.3d at 988 ("Rather, the plaintiff must prove that in determining the amount of funds legally available, the board 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.").

[112] *Id.* at 983 ("The two concepts, however, are not equivalent.").

[113] *Id.* at 990. Note, however, that the court's statement, both in *Klang* and in *ThoughtWorks*, that a limitation that is similar to "funds legally available" will be implied may be inconsistent with "a line of precedent [that] holds that preferences claimed by preferred stockholders must be clearly set forth in a certificate of incorporation or designation and will not be presumed or by the court." Shiftan v. Morgan Joseph Holdings, Inc., 57 A.3d 928, 936 (Del. Ch. 2012).

provision "does not eliminate the need for judgment . . . ."[114] Part III makes suggestions for drafting valuation provisions in light of this precedent.

4. **Provide for pro rata redemption in the preferences of redeemable preferred stock.** ThoughtWorks' board provided, in the preferences of its Series A preferred stock, for a contingency where ThoughtWorks lacked sufficient funds to pay for the redemption.[115] By providing that payments would be made pro rata until the redemption was effectuated, ThoughtWorks' board reduced its chances of being sued or held liable for breach of contract.[116] Language such as this is highly advisable, as discussed in Part III.

5. **Avoid 100% Redemptions.** ThoughtWorks' redemption provision required it to redeem "not less than 100%" of the plaintiff's preferred stock if they made a redemption demand after 5 years.[117] It is advisable to replace this "100%" requirement with language such as "to the extent allowed by law." This allows the issuer to completely redeem the preferred shareholder if it has the funds, and to partially redeem the

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114 *ThoughtWorks, Inc.*, 7 A.3d at 988; *see supra* notes 65–66 and accompanying text. A corporation could have no "funds legally available" yet be able to make a redemption using corporate property. *ThoughtWorks, Inc.*, 7 A.3d at 984.

115 *Id.* at 978–79.

116 ThoughtWorks reduced its chances of being sued for breach of contract by providing, in its charter, for procedures that were to be followed if the required redemption was not made. Since "[a] certificate of incorporation is viewed as a contract among shareholders, and general rules of contract interpretation apply to its terms[,]" ThoughtWorks could not be sued for following the terms of the contract, thus making the pro rata redemption. Matulich v. Aegis Commc'ns Essar Invs., Ltd., 942 A.2d 596, 600 (Del. 2008) ("The rules of construction which are used to interpret contracts and other written instruments are applicable when construing corporate charters and certificates of designation."); Waggoner v. Laster, 581 A.2d 1127, 1134 (Del. 1990).

117 *Id.* at 978.

preferred shareholder, with less cause for liability, if it lacks the funds.[118]

Having discussed the facts, issues, analysis, and practitioner takeaways from *ThoughtWorks*, Part II now turns to the Delaware Chancery Court's decision in *TCV*.

B. TCV

1. Facts

TradingScreen was a company that provided electronic securities trading services.[119] The plaintiffs in TCV were preferred stockholders of TradingScreen who had purchased Series D preferred stock in the company.[120] Section 7 of TradingScreen's Certificate of Incorporation made the Series D preferred stock redeemable if, after 5 years had passed, no other buyers for the preferred shares could be found.[121] Five years after purchasing the Series D preferred stock, the plaintiffs exercised their redemption rights pursuant to TradingScreen's charter.[122]

TradingScreen, like ThoughtWorks, lacked the funds needed to fully redeem its Series D preferred stock.[123] TradingScreen's board of directors determined that only $7.2 million was available to use in the redemption.[124] TradingScreen offered to make pro rata redemptions

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[118] Absent language that allows partial redemptions, or pro rata, redemptions, a cause of action for breach of contract may arise if the full redemption amount is not paid, depending on the language of the provision. *See* Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *6–7 (Del. Ch. June 27, 2014) (holding that breach of contract claim was adequately pleaded where no pro rata or partial redemption language was included in the preferences).

[119] *See supra* note 11.

[120] TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015).

[121] *Id.*

[122] *Id.* at *2.

[123] *Id.*

[124] *Id.*

until the balance of the redemption was paid.[125] The plaintiffs rejected the board's offer, demanded immediate payment, threatened suit unless payment was made, and claimed that failure to redeem their preferred stock constituted a "default" under TradingScreen's charter.[126] Any default would cause unpaid payments to incur interest in the amount of 13% per annum.[127]

Plaintiffs brought suit, claiming, among other things, that TradingScreen's failure to redeem its preferred stock constituted a violation of TradingScreen's charter and that interest on any unpaid amounts was required.[128] The plaintiffs filed a motion for judgment on the pleadings on these two claims.[129]

2. Issues

The Delaware Chancery Court resolved two primary issues in *TCV*:

1. Whether Delaware common law prohibits redemption where an issuer has sufficient surplus to make a redemption under DGCL § 160, yet would be rendered balance-sheet insolvent as a result of the redemption.
2. Whether a penalty provision, such as the interest provision presented in *TCV*, is enforceable where an issuer is unable to redeem its preferred stock.

3. Analysis

The Delaware Chancery Court, in an unpublished opinion, held that where a corporation has sufficient surplus under a balance sheet

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125 *Id.* It is notable that TCV's board *offered* to make pro rata redemptions, but there was no explicit language in TCV's charter that *required* pro rata redemptions in the event that TCV lacked funds needed to make the redemption. *Id.* Had this language been present, it is possible that TCV may have avoided suit for breach of contract altogether.

126 *Id.* at *3.

127 *Id.*

128 *Id.* at *3.

129 *Id.*

insolvency test, redemption is still prohibited if the redemption would cause the issuer to be unable to operate as a going concern.[130] Therefore, if a redemption would make an issuer cash flow insolvent, redemption is prohibited.[131] Since redemption could not be made under Delaware common law, the *TCV* Court refused to grant judgment on the pleadings for plaintiff's breach of contract claim,[132] reasoning that there was no legal obligation for TCV to make the redemption in contravention of Delaware common law.[133]

Furthermore, in *TCV*, the Delaware court refused to enforce a "penalty provision" providing for interest payments in the amount of 13% in the event of a default on payments.[134] The *TCV* Court held that TradingScreen never defaulted on a contractual duty, since, even though there was no clause in the redemption provision requiring that redemption be made out of legal funds, Delaware courts imply such a

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130 *Id.* at *6 ("TradingScreen may only 'legally' deploy funds for stock redemptions if doing so does not 'violat[e] Section 160 or other statutory or common law restrictions, including the requirement that the corporation be able to continue as a going concern and not be rendered insolvent by the distribution.'") (quoting SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 988 (Del. Ch. 2010), *judgment entered*, (Del. Ch. 2011), *aff'd*, 37 A.3d 205 (Del. 2011)).

131 *Id.* This result could have been predicted from the text of *ThoughtWorks*. *See supra* notes 51–66 and accompanying text.

132 *Id.* at * 7 ("Plaintiffs' motion must be denied as to their breach of contract claim under Count I because (i) the common law restricts TradingScreen's ability to redeem its shares when doing so would damage its ability to continue as a going concern and (ii) the Special Committee undertook a facially valid process finding that a full redemption would impair TradingScreen's continuing viability.").

133 *Id.* at *7–8.

134 *Id.* at *8.

limitation by law.[135] Where there was no default, there could be no penalty, so the plaintiffs were not entitled to interest payments.[136]

4. Takeaways from TCV

TCV provides issuers an unprecedented insight into the way Delaware courts may apply DGCL § 160 and the precedent of *ThoughtWorks*. Specifically, *TCV* shows issuers several things:

1. **Common law must be considered**. In *TCV,* while the actual numbers are redacted, it appears that TradingScreen had adequate surplus to effectuate the redemption.[137] However, the Delaware Chancery Court refused to require TradingScreen to redeem further shares of its stock, on the theory that doing so would render TradingScreen cash-flow insolvent, in violation of Delaware common law.[138]

2. **Even if omitted, Delaware courts may imply certain language.** Where an issuer omits language such as "funds legally available" or "consistently with Delaware law," *TCV* and *ThoughtWorks* indicate that the language will be implied.[139] It does not appear that Delaware courts will allow an issuer or preferred stockholder to draft around the restrictions of DGCL § 160 and Delaware common law.[140] Redemptions must be effectuated consistently with Delaware law.

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135 *Id.* at *5 ("TradingScreen's Charter, unlike ThoughtWorks's, does not explicitly restrict redemptions to those that can be made out of 'funds legally available.' However, in *ThoughtWorks,* this Court noted that were such language omitted from a corporation's charter, 'a comparable limitation would be implied by law.'") (quoting *ThoughtWorks, Inc.,* 7 A.3d at 990).

136 *Id.* at *8.

137 *Id.* at *5 ("Plaintiffs argue that TradingScreen's net asset value is at least $[redacted] million, and after deducting for the par value of issued stock, the Company's statutory surplus is more than sufficient to redeem their shares.").

138 *Id.* at *5–6.

139 *Id.* at *5.

140 *TCV VI, L.P.*, 2015 WL 1598045, at *6 ("while Delaware stockholders 'may by contract embody in the charter a provision departing from the [default] rules of the common law,' they are not permitted to 'transgress . . . a public policy

3. **Failure to redeem does not necessarily equal default**. The language of the penalty provision will control whether the penalty applies, but *TCV* makes it clear that penalty provisions that trigger merely upon "default" may not trigger due to an issuer's failure to redeem.[141] This is due, in part, to the fact that where the language of the redemption provision does not provide that redemption may only be effectuated in accordance with Delaware law, then courts will imply such limitation by law.[142]

As noted previously, *TCV* is unpublished. However, drafters can still learn from the logic and process used by the Delaware Chancery Court in resolving the issues presented in *TCV*, as evidenced by the takeaway points listed above. Part III now turns to the final case, *Brevan*.

C. Brevan

1. Facts

In *Brevan*, Spanish Broadcasting System ("SBS") issued Series B Preferred Stock ("the Series B") to the plaintiffs, a series of funds.[143] The preferences of the Series B resulted in the Series B functioning similarly to debt.[144] The Series B was redeemable, under certain conditions, at the option of both SBS and the holder.[145] The preferences of the Series B further provided that if "the Company fails to discharge any redemption or repurchase obligation with respect to the Series B

settled by the common law or implicit in the General Corporation Law itself.'") (quoting Sterling v. Mayflower Hotel Corp*.,* 93 A.2d 107, 118 (Del. 1952).

141 *Id.* at *8. This may vary depending on the language used and the document's definition of "default."

142 *Id.* at *5.

143 Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *1 (Del. Ch. June 27, 2014).

144 *Id.* at *2. For example, the preferences required SBS to pay a dividend quarterly, much like interest payments. *Id.*

145 *Id.*

Preferred Stock . . .” then a VRTE occurs and the holders of the Series B receive the right to fill seats on SBS' board of directors.[146]

On October 15, 2013, the holders of almost all of the Series B shares invoked their redemption rights.[147] SBS redeemed a small number of the outstanding Series B, and then claimed that it lacked funds to redeem any additional shares.[148] SBS further acknowledged that its failure to redeem triggered a VRTE.[149] The plaintiffs filed suit, alleging that SBS breached Section 7 of the Series B Certificate of Designations in two ways: (1) that SBS failed to comply with a clause that required SBS to take “all actions that could generate funds to repurchase the Series B” (hereafter the “all action” clause),[150] and (2) that SBS failed to assess what legally available funds may be raised by actions such as selling assets or issuing additional equity.[151]

In response, SBS argued that it was prohibited from taking certain actions to acquire financing with which to repurchase the Series B due to an indenture governing a previous debt offering the company executed.[152] SBS basically argued that, despite the language in the preferences requiring it to take “all actions” that could generate funds, certain activities were nonetheless prohibited, such as certain sales of assets.[153] Consequently, SBS moved to dismiss Count III of the plaintiff's Amended Complaint, which alleged “breach of contract based

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146 *Id.*

147 *Id.*

148 *Id.*

149 *Id.*

150 *Id.* (“First, the Plaintiffs read the second sentence of subsection (g)—that ‘[t]he Company shall take all actions required or permitted under the DGCL to permit any repurchase—as creating an obligation on the part of the Company to take all actions that could generate funds to repurchase the Series B . . . .’”).

151 *Id.* (“Second, the Plaintiffs contend that, even if SBS's obligation under subsection (g) is limited to the use of ‘legally available funds,’ that understanding itself implies an obligation on the part of the Company to assess what legally available funds may be raised . . . .”).

152 *Id.* at *3.

153 *Id.* at *2–3.

on the Company's failure to meet its obligations under Section 7 of the Certificate, governing repurchase of the Plaintiffs' Series B shares."[154]

2. Issues

The Delaware Chancery Court resolved three primary issues in *Brevan*:

1. Whether an "all action" clause included in a redemption provision requires issuers to take all possible actions that would result in generating legally available funds from which SBS could satisfy its repurchase obligations.
2. Does the phrase "funds legally available" also include funds "readily accessible through sales or borrowing?"
3. Whether an issuer's failure to redeem preferred stock may trigger a VRTE.

3. Analysis

At the heart of the first issue posed in *Brevan* is Section 7(g) of the Series B Certificate of Designations, which states: "(g) No Series B Preferred Stock may be repurchased except with funds legally available for the purpose. The Company shall take all actions required or permitted under the DGCL to permit any repurchase pursuant to this Section 7."[155] The plaintiffs argued that the phrase "the Company shall take all actions . . . permitted under the DGCL" obligated SBS to take all possible actions that would result in generating legally available funds from which SBS could satisfy its repurchase obligations, so long as those actions were not prohibited by the DGCL.[156] The defendants, however, argued instead that Section 7(g) merely required SBS to "take the necessary steps established by the DGCL for a Delaware corporation to repurchase shares."[157]

[154] *Id.* at *3. For purposes of this Article, analysis of the defendant's claim that plaintiff's lacked standing is omitted.

[155] *Id.* at *5.

[156] *Id.*

[157] *Id.*

Ultimately, the Delaware Chancery Court held in favor of SBS, finding the plaintiff's interpretation "unreasonable."[158] In coming to this conclusion, the *Brevan* Court analyzed parallel language found in Section 6 of the Series B Certificate of Designations, involving redemption at SBS's option.[159] When Section 6 was read together with Section 7, the Court reasoned that:

> [T]he only reasonable interpretation of [the no action clause in Section 7(g)] is that the parties intended to require the Company, if it elects to redeem shares, to accomplish such a redemption in compliance with the DGCL. Similarly, the only reasonable interpretation of the parallel language under Section 7 is that, when considering repurchase requests on behalf of the Series B holders, the Company must accomplish whatever repurchases it makes in compliance with the DGCL, and must do so only with legally available funds.[160]

Therefore, under *Brevan*, an "all action" clause does not require an issuer to take all actions possible to raise legally available funds.[161] Instead, an "all action" clause simply requires issuers to take the necessary steps established by the DGCL for a Delaware corporation to repurchase shares.[162] Despite this ruling, the *Brevan* Court held that the plaintiffs adequately plead a breach of contract claim against SBS and denied SBS' motion to dismiss.[163]

As for the second issue, SBS conceded that "funds legally available" does not consist solely of cash on hand but also of funds

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[158] *Id.*

[159] *Id.* at *6.

[160] *Id.*

[161] *Id.*

[162] *Id.*

[163] *Id.* at *8.

"readily accessible through sales or borrowing."[164] Furthermore, the court resolved the third issue by holding that SBS' failure to redeem all of its Series B constituted a VRTE.[165]

4. Takeaways from Brevan

In addition to the lessons provided by *ThoughtWorks* and *TCV*, *Brevan* provides new insights, such as:

1. **VRTEs may be enforced if an issuer fails to redeem**. While the *TCV* Court refused to enforce a penalty provision, it was conceded in *Brevan* that SBS' failure to redeem resulted in a VRTE.[166] However, this may vary depending on the language of the provision.
2. **"All action" clauses are narrowly construed.** "All action" clauses simply require issuers to take the necessary steps established by the DGCL for a Delaware corporation to repurchase shares.[167] However, as discussed *infra*, clauses that require issuers to take certain, specific actions to raise funds needed to make a redemption (hereafter "Specific Action clauses") may be enforced due to the contractual nature of preferred stock preferences.[168]
3. **"Funds legally available" includes funds readily accessible through sales or borrowing.** When calculating surplus and available funds to be used in a redemption, an issuer's board of

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164 *Id.* at *6 ("legally available funds do not consist solely of available cash, but also of funds readily accessible through sales or borrowing") (internal citation omitted).

165 *Id.* at *7 (noting that failure to redeem the Series B Preferred "unquestionably results in a VRTE").

166 *Id.*

167 *Id.*

168 Waggoner v. Laster, 581 A.2d 1127, 1134 (Del. 1990) (noting that Charter provisions constitute a contract among shareholders); Matulich v. Aegis Commc'ns. Grp., Inc., 942 A.2d 596, 600 (Del. 2008) ("The rules of construction which are used to interpret contracts and other written instruments are applicable when construing corporate charters and certificates of designation.").

directors must not only confine their analysis to merely cash on hand, but also analyze funds that could be accessed through selling assets or borrowing.[169]

Having completed analysis of the facts, issues, holdings, and takeaways of *ThoughtWorks*, *TCV*, and *Brevan*, we turn now to Part III, a series of drafting recommendations and practices designed to help issuers both avoid and prevail at litigation resulting from an uneffectuated redemption.

PART III: DRAFTING RECOMMENDATIONS & SUGGESTED PRACTICES

Having reviewed Delaware law restricting preferred stock redemptions in Part I and cases where issuers were sued for failing to redeem their preferred stock in Part II, a question remains—is a change in drafting practices really necessary? After all, *ThoughtWorks* and *TCV* are pro-issuer decisions.[170] However, *Brevan* shows that a plaintiff may properly plead a claim for breach of contract against an issuer as a result of the issuer's failure to redeem its preferred stock.[171] This indicates that changes are necessary.

Beyond *Brevan*, additional Delaware cases, such as *Shiftan v. Morgan Joseph Holdings, Inc.*, suggest that contemporary drafting practices require revision.[172] For example, under *Shiftan*, it is arguable that protection provided to issuers by the *ThoughtWorks* and *TCV* Courts'

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169 SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 988 (Del. Ch.2010), *aff'd*, 37 A.3d 205 (Del. 2011) (noting that funds are "'available' (in the sense of on hand *or readily accessible through sales or borrowing*) . . .") (emphasis added).

170 In *ThoughtWorks* and *TCV*, the defendant issuers prevailed. *See* cases cited *supra* notes 109, 133, 136 and accompanying text.

171 *Brevan*, 2014 WL 2943570, at *8. The *Brevan* Court held that the plaintiff properly pled a breach of contract claim, even though DGCL § 160 and Delaware common law prohibited the issuer from making the redemption. *Id.*

172 Shiftan v. Morgan Joseph Holdings, Inc., 57 A.3d 928, 933 (Del. Ch. 2012) (holding that where a mandatory redemption was not premised on the existence of "funds legally available" there nevertheless existed a "an unconditional obligation to redeem the Series A Preferred Stock, subject only to the statutory capital requirements imposed by 8 *Del. C.* § 160.").

implication of limitations similar to "funds legally available," even where such language is absent from the preferences, is inconsistent with "a line of precedent hold[ing] that preferences claimed by preferred stockholders must be clearly set forth in a certificate of incorporation or designation and will not be presumed *or implied* by the court."[173] Furthermore, issuers must ask themselves whether protection by implication is sufficient to safeguard their interests.[174] To be safe, contemporary drafters must not rely exclusively on protection by implication but rather on protections explicitly incorporated into their redemption provisions.

In addition, the idea that "contracts are to be interpreted as written, and effect must be given to their clear and unambiguous terms" may result in liability for issuers where the preferences of the preferred stock state that if redemption is not made, then the issuer is liable, regardless of whether the redemption is legally impossible.[175] It is conceivable that Delaware courts, as a matter of public policy, will not enforce such a provision.[176] However, the Delaware Chancery Court held that the plaintiffs in *Brevan* adequately plead a case of breach of contract, even where SBS claimed that it lacked funds and could not effectuate a redemption consistently with Delaware law.[177] Therefore, to

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[173] *Id.* at 936 (emphasis added).

[174] TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015). In referencing protection by implication, this Part is referencing protection in the form of implied limitations similar to the phrase "funds legally available." *Id.* This Article advocates that rather than relying on courts to imply protections against liability for non-redemption of preferred stock, issuers should supply their own protection in the preferences.

[175] *Id.* As an example of this, the Delaware Chancery Court did not challenge SBS' concession in *Brevan* that non-redemption was a VRTE, even though redemption was impossible under Delaware common law. *Brevan*, 2014 WL 2943570, at *7. This argument applies to penalty provisions and VRTEs as well as breach of contract liability.

[176] *TCV VI, L.P.*, 2015 WL 1598045, at *6; Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952).

[177] *Brevan*, 2014 WL 2943570, at *8.

ensure protection from liability, changes in drafting practices are necessary.

By following the suggested practices listed in this Part, issuers can (1) minimize, to the greatest extent possible, their potential liabilities for failing to redeem preferred stock; and (2) maximize their chances of being able to redeem their preferred stock when necessary, thus avoiding liability altogether. By minimizing liability and maximizing the issuers' ability to redeem its preferred stock, issuers can save time, money, and human resources. The following are suggested practices for issuers, to be discussed individually in detail:

1. **Eliminate mandatory redemptions and discretionary put rights altogether**. Instead, when possible, use call rights. If you must include mandatory redemption provisions or discretionary put rights, include language that redemption is not required where redemption is "prohibited by law."

2. **Draft with specificity.** Provide, in the preferences of the preferred stock, for pro rata redemption in the event that Delaware law restricts or prohibits a complete redemption. Issuers may also desire to circumvent valuation challenges by establishing a valuation methodology for valuing the issuer's net assets before issuing its preferred stock.

3. **Avoid negative drafting.** Where possible, do not include VRTEs, penalty provisions, or "specific action" clauses that require the company to seek financing from particular sources when calculating and gathering funds for the redemption. If you must include penalty provisions or VRTEs, attempt to structure the triggers so they will not apply where redemption is forbidden under DGCL § 160 or Delaware common law.

A. Eliminating Mandatory Redemption Rights and Discretionary Put Rights; Excuse Redemptions "Prohibited by Law"

To begin, *ThoughtWorks*, *TCV*, and *Brevan* share one common characteristic—the preferences of each issuer's preferred stock contained mandatory redemption rights that obligated the issuers to redeem the

preferred shareholders under conditions outside of the issuer's control.[178] Whenever an issuer relinquishes control over the timing or occurrence of a redemption, the threat emerges that redemption rights may trigger at an inopportune time where the issuer lacks funds to effectuate the redemption.[179] By replacing mandatory redemption provisions and discretionary put rights with call rights, issuers eliminate the threat of lawsuits before they even begin.[180] If an issuer uses call rights, then preferred shareholders would not be able to sue the issuer for failing to redeem its stock, since the issuer had the right, but not the obligation, to redeem. Therefore, the easiest way for issuers to avoid liability is to stop using mandatory redemptions and discretionary put rights altogether.

Unfortunately, issuers will not always be able to control whether a mandatory or discretionary redemption is included in the preferences of their preferred stock.[181] In *ThoughtWorks*, for example, the plaintiffs—preferred stockholders—negotiated the mandatory put provision as a contingency in case an initial public offering was not executed.[182] In fact, an issuer's refusal to include a mandatory redemption provision may hurt

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178 *See supra* notes 88, 121, 145 and accompanying text.

179 It is impossible for an issuer to know, with precise certainty, that they will have sufficient surplus in the future to effectuate redemption when required. Of course, well-capitalized issuers have far less risk than issuers who are in financial distress. Apple, Inc., for example, does not have to worry about insolvency from a practical standpoint and thus can draft redemption provisions with little risk. However, an issuer drifting on the edge of insolvency must consider the possibility that it will be unable to redeem its preferred shares before issuing additional redeemable equity.

180 For example, if the preferred stock in *ThoughtWorks* was redeemable at the option of the issuer, then ThoughtWorks could have evaluated its surplus in 2005, determined that it could not redeem the preferred stock, and avoided the lawsuit altogether, since it would have had no legal duty to redeem.

181 In negotiating, an investors' desire for a definitive exit strategy via a mandatory redemption may lead issuers to concede to a mandatory redemption or discretionary put right. William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1865 (2013) (noting that with venture capital, "exit via mandatory redemption is hardwired into the business model.").

182 SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 978 (Del. Ch. 2010), *judgment entered*, (Del. Ch. 2011), *aff'd*, 37 A.3d 205 (Del. 2011).

the marketability of its preferred stock.[183] The question remains, how can an issuer reduce its liability where it has no other option but to include a mandatory redemption or put right in the preferences of its preferred stock?

Simply inserting a clause into the redemption provision that states that redemption is not required if Delaware law prohibits the redemption solves this problem.[184] Due to contractual nature of preferred stock in Delaware, if the issuer's charter or the certificate of designations for the preferred stock says that the preferred stock cannot be redeemed if the redemption would violate Delaware law, then Delaware courts will likely enforce such a provision.[185] In addition, preferred stockholders would be precluded from bringing a breach of contract lawsuit against the issuer in such a situation because redemption would not be required by the express terms of the contract (the certificate or charter).[186] Consequently, an issuer can drastically reduce

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[183] Some prospective purchasers may treat preferred stock closely to debt and insist on a mandatory redemption as akin to a maturity date. *See* Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *2 (Del. Ch. June 27, 2014) (noting that "the Series B preferred also function like debt instruments by providing what may be likened to a maturation date."); William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1865 (2013) (noting that mandatory redemption is endemic to some investor's business models).

[184] This language has also been suggested as a replacement for the phrase "funds legally available." C. Stephen Bigler & Jennifer Veet Barrett, *Delaware Insider: Drafting A Mandatory Put Provision for Preferred Stock After ThoughtWorks*, BUS. L. TODAY, January 2012, at 1, 3.

[185] Matulich v. Aegis Commc'ns. Grp., Inc., 942 A.2d 596, 600 (Del. 2008) ("The rules of construction which are used to interpret contracts and other written instruments are applicable when construing corporate charters and certificates of designation."); SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 987 (Del. Ch. 2010), *judgment entered*, (Del. Ch. 2011), *aff'd*, 37 A.3d 205 (Del. 2011).

[186] *Matulich*, 942 A.2d at 600. This assumes that the issuer's board adequately values surplus and follows the requirements of DGCL § 160. For example, a preferred shareholder may be able to sue for breach of contract if the issuer's board of directors value assets in a way that is inconsistent with the Delaware Supreme Court's holding in *Klang*. Klang v. Smith's Food & Drug Centers,

its liability by avoiding mandatory redemptions and put rights altogether and, when necessary, adding language that states that redemption is not required if prohibited by law.

B. *Draft with Specificity; Think of the End from the Beginning*

ThoughtWorks, TCV, and *Brevan* show that issuers sometimes fail to contemplate the way courts interpret redemption rights where redemption is impossible.[187] To minimize liability, issuers must carefully draft the preferences of their preferred stock with redemption restrictions in mind. In particular, an issuer can minimize its liability by providing, in the preferences of their preferred stock, for (1) pro rata redemption, to the extent of surplus or cash available, where a complete redemption cannot be effectuated; and (2) a valuation methodology to be used for valuing the issuer's net assets while calculating surplus.

First, in the event that a complete redemption is forbidden by DGCL § 160 or Delaware common law, providing for pro rata redemption helps issuers avoid breach of contract claims.[188] Pro rata redemption allows preferred stockholders to be paid to the extent permitted by law.[189] A pro rata redemption clause will likely be enforced,[190] and could be used by courts as a basis for dismissing a breach of contract claim, since the preferences of a preferred stock, and thus the pro rata redemption clause, constitute a contract among shareholders.[191]

Pro rata redemption can, and likely should, be used in conjunction with Part III(a)'s suggestion that the language "prohibited

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Inc., 702 A.2d 150, 152 (Del. 1997) (discussing appropriate methodologies for valuing a corporation's assets).

[187] *See* cases cited *supra* notes 88, 121, 145 and accompanying text.

[188] For example, ThoughtWorks' preferred stock preferences included a pro-rata redemption clause. *See* cases cited *supra* note 115 and accompanying text. They were not sued for breach of contract. *Id.*

[189] *Id.* In theory, the idea that the shareholders are receiving some compensation, even if not the full amount of the redemption, may reduce a shareholder's desire to bring suit.

[190] Pro rata redemption clause was enforced in *ThoughtWorks*. *Id.*

[191] *Id.*

by law" be added to the preferences. For ideal protection, these two clauses, the "prohibited by law" clause and the "pro rata redemption" clause, can be bundled together. When combined, these clauses (1) absolve the issuer of any legal duty to make a complete redemption if the complete redemption would be restricted; and (2) authorize the issuer to effectuate a pro rata redemption, to the extent permitted by law. Suggested language could look like this:

> [ ] Notwithstanding Section [ ], no redemption shall be required if the redemption is prohibited by law. If redemption is prohibited by law, the Company shall effectuate the redemption pro rata, to the extent permitted by law, according to the number of shares held by each holder of Preferred Stock. The pro rata redemption shall continue, to the extent permitted by law, on a quarterly basis until the redemption is fully discharged.[192]

By drafting with specificity and providing for pro rata redemptions, issuers can resolve any ambiguities in the redemption process, maximize the probability that they will be able to redeem at least some of the preferred stock, and shield themselves from breach of contract liability.

Second, issuers may desire to set out a method for valuing corporate assets in the preferences of their preferred stock. The valuation of an issuer's net assets is a critical part of the analysis underlying redemption restrictions, since "surplus" under DGCL § 160 is derived from the difference between "capital" and "net assets."[193] A

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[192] The actual language a practitioner should use will vary widely depending on the nature of the instrument, the preferences included, and the drafting desires of the issuer and their counsel. This language is only a suggestion; what is important is drafting the preferences in a way that eliminates the legal duty of an issuer to completely redeem stock where a full redemption is prohibited under DGCL § 160 or Delaware common law, yet be able to effectuate a pro rata redemption in such a situation.

[193] *See* cases cited *supra* notes 48–50 and accompanying text.

common theme that can be observed in *ThoughtWorks* and *TCV* is that preferred stockholders, in bringing suit against issuers for failing to redeem, often cite issues concerning the issuer's valuation of assets.[194]

Issuers can circumvent valuation challenges by simply including a valuation method or third party valuation expert, in the preferences of their preferred stock.[195] Including a valuation method or export is distinct, and should not be confused with, including valuation provisions that require the issuer to value its assets as highly as possible, as seen in *ThoughtWorks*.[196] This type of provision is discussed above. Instead, the purpose of establishing a valuation method or expert is to prevent valuation from being an issue in lawsuits, as was the case in *ThoughtWorks* and *Klang*.[197]

It is true that including a valuation method or expert in the preferences of preferred stock may provide superfluous protection, since established case law clearly provides issuers with discretion in valuing assets.[198] However, to remove all doubt, issuers can protect themselves against suits concerning the valuation of net assets by selecting a valuation method or expert before issuing the preferred stock and memorializing such in the preferences. In this way, drafting with specificity as to valuation can protect issuers from liability.

Likewise, issuers may want, or be forced in negotiation, to include a provision that states that the issuer's board of directors must value its corporate assets as highly as possible under the law. This type

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[194] SV Inv. Partners, LLC v. ThoughtWorks, Inc., 7 A.3d 973, 988–89 (Del. Ch. 2010), *judgment entered*, (Del. Ch. 2011), *aff'd*, 37 A.3d 205 (Del. 2011); TCV VI, L.P. v. TradingScreen Inc., No. CV 10164-VCN, 2015 WL 1598045, at *1 (Del. Ch. Feb. 26, 2015), *appeal refused*, 115 A.3d 1216 (Del. 2015) (noting that "TCV Funds and TradingScreen were unable to agree on the Preferred Stock's fair market value . . . .").

[195] Agreeing to a valuation method or expert in the preferences will likely be enforced, since the preferences are construed as a contract among shareholders. Matulich v. Aegis Commc'ns. Grp., Inc., 942 A.2d 596, 600 (Del. 2008).

[196] *ThoughtWorks, Inc.*, 7 A.3d at 988–89.

[197] Klang v. Smith's Food & Drug Centers, Inc., 702 A.2d 150, 152 (Del. 1997) (discussing dispute concerning methods of valuing a corporation's assets).

[198] *See* cases cited *supra* note 52–53 and accompanying text.

of provision can maximize the probability that an issuer will be able to redeem its preferred stock by increasing net assets, but not capital.[199] In the same way, instructing the issuer's board of directors to refrain from allocating any surplus as capital can have a similar effect.[200] Therefore, an issuer can increase its chances of being able to redeem its preferred stock by maximizing net assets and surplus, yet limiting capital.

C. Avoid Negative Drafting

Finally, issuers can minimize their liability by avoiding negative drafting. For example, in *Brevan* and *TCV*, the plaintiffs argued that penalty provisions or VRTEs were triggered by the issuer's failure to redeem its preferred stock.[201] Obviously, penalty provisions, such as paying interest on the amount of the unredeemed stock, or VRTEs are undesirable for issuers. Consequently, issuers should attempt to exclude penalties or VRTEs from the preferences of the preferred stock altogether.

However, it is possible that issuers, as a matter of negotiation, will sometimes be persuaded (or forced) to accept some forms of penalty provisions or VRTEs.[202] This is particularly true where the preferred stockholder desires for the preferred stock to function similarly to debt.[203] When this happens, an issuer should structure the triggering mechanism for the penalty or VRTE so that the provision will not apply where redemption is prohibited by Delaware law. Sample language could read as follows:

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199 *See* DEL. CODE ANN. tit. 8, § 154 (2010). By increasing the probability that a redemption will occur, issuer's decrease their chances of being sued for failing to redeem.

200 *Id.*

201 *See* cases cited *supra* notes 134, 166 and accompanying text.

202 Douglas G. Smith, *The Venture Capital Company: A Contractarian Rebuttal to the Political Theory of American Corporate Finance?*, 65 TENN. L. REV. 79, 152 (1997) (noting that "[c]ompanies that seek venture capital financing are generally left with no other alternatives for financing and are therefore in a weak bargaining position[,]" which increases the probability that an issuer will be forced to accept VRTE or penalty provisions in some situations).

203 *See* cases cited *supra* note 11 and accompanying text.

> Notwithstanding Section [ ], no [Voting Rights Triggering Event/Penalty] shall apply where redemption of the Preferred Stock is prohibited by law.[204]

By eliminating penalty provisions and VRTEs, or at least modifying the triggering events, issuers can limit their potential liability.

In addition, issuers should beware of "specific action" clauses. While *Brevan* makes it clear that "all action" clauses will not be construed as requiring an issuer to take all actions permitted by law to effectuate a redemption, the *Brevan* Court leaves open the possibility that a "specific action" clause could be enforced.[205] Due to the contractual nature of preferred stock, if an issuer agrees in the preferences, to undertake specific actions, such as selling certain assets,[206] to effectuate a redemption, that agreement will likely be enforced,[207] provided that the action to be taken is not inconsistent with Delaware law.[208]

In sum, issuers should avoid negative drafting entirely. Where negative drafting is required, issuers should consider redemption restrictions when drafting their provisions and exclude an issuer's failure to redeem, due to redemption restrictions, from the list of triggering events.

CONCLUSION

In conclusion, issuers should be mindful of redemption restrictions imposed by Delaware law when they draft the preferences

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[204] This language is only a suggestion; what is important is drafting the triggers of the penalty provision or VRTE, so that nonredemption caused by DGCL § 160 or Delaware common law will not trigger the penalty/VRTE.

[205] *See* cases cited *supra* notes 167–68 and accompanying text.

[206] This in itself can create liability if the issuer agrees, in a specific action clause, to sell an asset that it previously agreed it wouldn't sell in a prior agreement. Brevan Howard Credit Catalyst Master Fund Ltd. v. Spanish Broad. Sys., Inc., No. CIV.A. 9209-VCG, 2014 WL 2943570, at *1 (Del. Ch. June 27, 2014). For example, in *Brevan*, SBS was in a pickle because it previously agreed, in a bond indenture, not to sell certain assets. *Id.*

[207] Matulich v. Aegis Commc'ns Grp., Inc., 942 A.2d 596, 600 (Del. 2008).

[208] Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952).

for redeemable preferred stock. The value and flexibility redemption provisions afford issuers make redemption rights attractive additions to the preferences. Nevertheless, as observed in *ThoughtWorks*, *TCV*, and *Brevan*, redemption restrictions can transform redemption rights into a potential source of liability for issuers.

To limit liability, issuers can do two things: (1) draft the preferences in a way that maximizes the issuer's ability to make a required redemption when redemption is required; and (2) including language in the preferences that limits the issuer's liability for failing to redeem its stock. Issuers can increase their probability of being able to redeem their preferred stock by adding valuation provisions, allocating as little of surplus as possible to capital, and avoiding penalty provisions or VRTEs, which increase the cost of a redemption.

Meanwhile, issuers can limit their liability for failing to make a redemption by taking three simple steps:

1. Excluding mandatory redemption rights and discretionary put rights altogether. Where these provisions must be included, provide that redemption is excused where effectuating the redemption is prohibited by law in the preferences;
2. Drafting with specificity by: (1) providing for pro rata redemption if a complete redemption is restricted; and (2) selecting a valuation method or expert ahead of time; and
3. Avoiding negative drafting by eliminating or limiting penalty provisions, VRTEs, and "specific action" clauses.

By following these suggested practices, issuers will save time, money, and human capital by avoiding liability and lawsuits, while keeping their preferred shareholders happy by maximizing the probability that they will be redeemed when promised. This Article helps issuers' counsel understand the perils posed by redemption restrictions under Delaware law and creatively address these issues via careful drafting. Overall, redemption restrictions can be reduced from a major hurdle to a minor obstacle by understanding the law, applying precedent while drafting preferred stock preferences, and following these suggested practices.