

SUPERMAJORITY VOTING RIGHTS FOR CUMULATIVE PERPETUAL PREFERRED STOCK

Camille Mennen

MEMORANDUM

TO: Senior Partner
FROM: Camille Mennen
RE: Supermajority Voting Rights for Cumulative Perpetual Preferred Stock

I. INTRODUCTION

You asked that I draft supermajority voting rights provisions for the Certificate of Designations for a series of preferred stock that University, Inc. (“University”), a Delaware corporation, will issue to our client, Patricia Knox (“Knox”), a Tennessee resident. The draft provisions are attached as Rider A. With your approval, the supermajority voting provisions in Rider A will be incorporated into the Certificate of Designations.

This memorandum provides the transactional context for the Series A Cumulative Preferred Stock, identifies the legal issues involved in applying the relevant law to our client’s concerns, and analyzes the drafting decisions that address these issues. Terms not defined in this memorandum maintain their definitions from Rider A or the following glossary.

II. TRANSACTIONAL CONTEXT

Knox, our client and a Tennessee resident, is a founder of University, a Delaware public corporation that manufactures and sells collegiate apparel around the country. With in-store sales declining and operational challenges mounting due to COVID-19, University has faced significant financial difficulties since March 2020. To continue operations and explore ways to adapt its business to a socially distanced market, University needs capital. Knox wants to pursue a private placement with University

to contribute capital to help University succeed despite these unexpected, temporary challenges. The parties have agreed that University will issue preferred stock to Knox in this private placement.

Knox is concerned about what business decisions University might make in light of such unprecedented times and financial difficulties and how those decisions could affect her investment. Consequently, Knox would like increased control over the approval of changes to University's Certificate of Incorporation or Certificate of Designations that could be detrimental to her investment. Knox would also like to protect her return on investment by maintaining the priority of the preferred stock she will receive in this offering. I have focused on this protective purpose when making drafting decisions. University appreciates Knox's concerns and has expressed that it would like to agree to provisions that honor her interests, but the board has also expressed that it is conscious of its fiduciary duties to all University stockholders and does not want to authorize preferred stock rights that would constitute a violation of those duties.

The offering will consist of Series A Cumulative Perpetual Preferred Stock ("Series A Preferred Stock") issued by University to Knox. University has only issued one class of common stock, which is listed on the New York Stock Exchange ("NYSE") and has a current trading price of twenty dollars per share. The common stock is broadly held; Knox only owns three percent of University's outstanding common stock. Under the General Corporation Law of the State of Delaware ("DGCL") Section 151, University's Certificate of Incorporation authorizes the board to issue 98,000,000 shares of common stock.¹ 90,000,000 of these shares have been issued and are outstanding. University has not issued preferred stock before, but its Certificate of Incorporation authorizes the board to issue 2,000,000 shares of preferred stock and provides for "blank check preferred stock" under DGCL Sections 151(a) and (g).² The blank check preferred stock provision allows the board to authorize the issuance of preferred stock and to set, by resolution, "the voting powers, designations, preferences, rights, and qualifications" of such stock.³ Thus, University will issue 1,500,000 shares of Series A Preferred Stock to Knox, par value of five cents per share and an initial value of thirty-five dollars per share,

¹ DEL. CODE ANN. tit. 8, § 102(a)(4) (2020).

² *Id.*

³ tit. 8, § 151(a), (g).

for Knox's \$52,500,000 investment, as authorized by DGCL Section 161 and the Certificate of Incorporation.⁴

This offering is a private placement that qualifies for an exemption from registration under Section 4(a)(2) of the Securities Act of 1933.⁵ Another associate is addressing the securities regulations details of this transaction. This associate will apply for an exemption from registration to comply with the Securities Exchange Act of 1934 and the Securities Act of 1933 and will take additional measures to comply with the relevant Delaware securities law.⁶ Additionally, because University is listed on the NYSE, it must follow the Listed Company Manual.⁷ However, in this transaction, University does not need to seek shareholder approval under Section 312.03(c).⁸

III. DRAFTING CHOICES

Below I identify key issues I resolved in drafting the supermajority voting provisions for this transaction.

I. Can supermajority voting rights fully protect Knox's investment in the Series A Preferred Stock from amendments to the Certificate of Incorporation or the Certificate of Designations?

One of the most important issues for Knox is that her investment will be protected from changes to University's Certificate of Incorporation or Certificate of Designations or any similar document that would adversely affect the rights or preferences of the Series A Preferred Stock. A provision requiring a supermajority class vote to approve an amendment, alteration, or repeal of the certificate of incorporation or the certificate of designations is a common feature of a certificate of designations for supermajority voting preferred stock.⁹ Both parties agree

⁴ See tit. 8, § 161.

⁵ 15 U.S.C. § 77d(a)(2).

⁶ DEL. CODE ANN. tit. 6, § 73-208(b) (2020).

⁷ See N.Y. STOCK EXCH., LISTED COMPANY MANUAL, PREFACE TO THE NEW EDITION, https://nyseguide.srorules.com/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-0 (last visited Oct. 10, 2021).

⁸ *Id.* § 312.03(c)(2).

⁹ See, e.g., Goldman Sachs Grp., Restated Certificate of Incorporation of the Goldman Sachs Group, Inc. (Ex. 3.1, Form 10-Q) (Aug. 5, 2019); Occidental Petrol. Corp.,

that this is a normative and acceptable supermajority voting right for the Series A Preferred Stock. However, Delaware decisional law indicates that such provisions can leave the preferred stock vulnerable to amendments to the certificate of incorporation that occur through merger or consolidation.¹⁰ Thus, Knox desires a provision that also protects against such amendments.

II. Can the Supermajority Voting Rights protect Series A Preferred Stock's priority against only stock or all financial instruments?

Another important issue for Knox is protecting her investment's priority as to dividends or the distribution of assets upon the liquidation, dissolution, or winding up of University. This priority is particularly crucial to Knox in light of University's recent financial difficulties. Under Delaware law, a series of preferred stock may be granted supermajority voting rights which are required to authorize the issuance of or increase in the amount of stock or instruments convertible into or carrying a right to purchase stock ranking prior to the preferred stock with respect to dividends or the distribution of assets upon liquidation, dissolution, or winding up of the corporation.¹¹ Both parties have agreed to the inclusion of this normative provision, but Knox wants to protect the Series A Preferred Stock's priority against all instruments issued by University, not only against stock. However, Delaware law constrains the priority preferred stock may enjoy.¹²

III. Do the Supermajority Voting Rights protect Knox's investment without compromising the University board's fiduciary duties to University's common stockholders?

Finally, University and Knox negotiated whether the Series A Preferred Stock would possess supermajority voting rights relating to all matters submitted to holders of University Common Stock not already

Securities Purchase Agreement (Ex. 10.1, Form 8-K) (May 3, 2019); TCF Fin. Corp., Amended and Restated Certificate of Incorporation of TCF Financial Corporation (Ex. 3.1, Form 10-Q) (May 3, 2018); Phillips Van Heusen Corp., Certificate of Designations of Series A Convertible Preferred Stock (Ex. 3.1, Form 8-K) (May 12, 2010).

¹⁰ See *Elliot Assocs., L.P. v. Avatex Corp.*, 715 A.2d 843, 853 (Del. 1998).

¹¹ See *Dart v. Kohlberg, Kravis, Roberts & Co.*, 1985 Del. Ch. LEXIS 416, at *12-13 (May 6, 1985).

¹² See DEL. CODE ANN. tit. 8, § 281 (2020).

included in the Section 7(b) provisions. Knox suggested this additional provision because she wants the right to exercise more control over University's decisions in its time of financial difficulty to further protect her significant investment.¹³ However, University expressed concern about giving such power to a series of preferred stock, citing the board's fiduciary duties to University and all University stockholders.¹⁴

IV. ANALYSIS OF DRAFTING CHOICES

I. Protection against Amendments to the Certificate of Incorporation Materially and Adversely Affecting the Rights and Preferences of Series A Preferred Stock

In Section 7(b)(i) of Rider A, I drafted the supermajority voting rights provision to require the affirmative vote of sixty-six and two-thirds percent of all of the shares of the Series A Preferred Stock before authorizing any amendment to University's Certificate of Incorporation that will "adversely affect the powers, preferences, privileges or rights of the Series A Preferred Stock."¹⁵ This language will allow Knox to use the supermajority voting rights to protect the rights and privileges of Series A Preferred Stock from disadvantageous amendments and, therefore, protect her equity investment. In drafting this provision, I relied on Delaware precedent transaction documents and decisional law.¹⁶ Most certificates of designations for preferred stock with supermajority voting

¹³ See Ben Walther, *The Peril and Promise of Preferred Stock*, 39 DEL. J. CORP. L. 161, 164 (2014) ("[P]referred shareholders must protect themselves with contract-like covenants in the certificate of designation . . .").

¹⁴ *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 955 (Del. 1985) ("[O]ur analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interest of the corporation's stockholders."); William M. Lafferty, Lisa A. Schmidt, & Donald J. Wolfe, Jr., *A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law*, 116 PA. ST. L. REV. 837, 841 (2012) ("When making corporate decisions, directors must fulfill the traditional duties of care and loyalty in order to satisfy their fiduciary obligations to the corporation and its stockholders."); Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 681–82 n.51 (2009) ("good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty") (quoting *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).

¹⁵ See *infra* Rider A(b)(i).

¹⁶ See sources cited *supra* note 9.

rights include a provision that provides voting rights over such amendments.¹⁷

To provide Knox with greater voting rights in this provision and, therefore, greater protection for the rights and privileges of Series A Preferred Stock, I tailored the language of this provision to also apply to amendments to the Certificate of Incorporation that take effect through “merger, consolidation, or otherwise.” This expansion was necessary because, under DGCL Section 251, a merger or consolidation can affect a certificate of incorporation in a variety of ways.¹⁸ Moreover, while the term “otherwise” may appear imprecise, I included the phrase “merger, consolidation, or otherwise” to invoke specific Delaware decisional law that supports preferred stockholders’ right to a class vote on a merger or consolidation, described in DGCL Section 251(a), which will affect a corporation’s certificate of incorporation.¹⁹

This additional language provides critical protection for Knox’s investment because Delaware courts consistently acknowledge that this language is outcome determinative.²⁰ Delaware courts will not construe a voting rights provision as giving stockholders the right to vote on amendments to a certificate of incorporation effectuated through merger or consolidation without this phrase.²¹ University will likely accept this additional language because it retains the qualification that an amendment subject to a vote by holders of Series A Preferred Stock must be an amendment that would “adversely affect the powers, preferences, privileges or rights of the Series A Preferred Stock.” Thus, Knox would not possess supermajority voting power over every DGCL Section 251(a) event.

¹⁷ See sources cited *supra* note 9.

¹⁸ *Elliott Assocs., L.P. v. Avatex Corp.*, 715 A.2d 843, 850 (Del. 1998) (explaining that a merger or consolidation can affect the certificate of incorporation through amendments to the certificate of incorporation, displacement and substitution of the certificate of incorporation by merger, or displacement and substitution of the certificate of incorporation by consolidation).

¹⁹ *Elliott Assocs.*, 715 A.2d at 855; *Greenmont Capital Partners I, LP v. Mary’s Gone Crackers, Inc.*, No. 7265-VCP, 2012 Del. Ch. LEXIS 236, at *20 (Sept. 28, 2012); *Benchmark Capital Partners IV, L.P. v. Vague*, No. 19719, 2002 Del. Ch. LEXIS 90, at *30 (July 15, 2002).

²⁰ *Elliott Assocs.*, 715 A.2d at 855.

²¹ *Benchmark Capital*, 2002 Del. Ch. LEXIS 90, at *30; see also *Greenmont Capital*, 2012 Del. Ch. LEXIS 236, at *20 (citing *Warner Commc’ns, Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962, 967 (Del. 1989) (“[T]he principle of Delaware Corporation law that any rights or preferences of preferred stock must be expressed clearly.”)).

II. Priority of Series A Preferred Stock

In Section 7(b)(ii) of Rider A, I drafted the supermajority voting rights provision to require a vote of two-thirds of the holders of Series A Preferred Stock to issue, authorize, or increase the amount of stock with priority over the Series A Preferred Stock. Also, a two-thirds vote of Series A Preferred Stock holders is required to issue or authorize any obligation or security convertible into or evidencing the right to purchase a class or series of stock with such priority. In drafting this provision, I relied on Delaware precedent transaction documents and decisional law, which support the validity of this supermajority voting right.²² I included this provision in the supermajority voting rights because it allows Knox, through the voting rights she will possess as a holder of Series A Preferred Stock, to protect her financial rights as a Series A Preferred Stockholder by maintaining her investment's priority as to dividends and the distribution of assets upon liquidation, dissolution, or winding up of University.

The protection provided by this provision has a critical vulnerability, however. The provision only applies to the issuance, authorization, or increase in the amount of *stock* or the issuance or authorization of instruments that may convert *into stock*. Due to the provision's limited application, Knox will not be able to protect her investment's priority against other instruments. This weakness has also been discussed in Delaware decisional law.²³

I considered altering the boilerplate language of this provision to require a supermajority vote of approval from Series A Preferred Stockholders for the issuance, authorization, or increase in the amount of *any instrument* ranking prior to the Series A Preferred Stock in order to better protect Knox's financial rights. However, this language, or a substantively similar revision to the provision, is not possible because DGCL Section 281 provides that debt will always have priority over

²² Northern Trust Corp., Certificate of Designation of Series E Non-Cumulative Perpetual Preferred Stock (Ex. 3.1, Form 8-K) (Oct. 31, 2019); Goldman Sachs Grp., Inc., *supra* note 9; Blockchain Holdings Capital Ventures, Inc., Certificate of Designation, Preferences and Other Rights of the Class A Preferred Super Majority Voting Stock (Ex. 4.1, Form 8-K) (Sept. 17, 2018).

²³ *Dart v. Kohlberg, Kravis, Roberts & Co.*, No. 7366, 1985 Del. Ch. LEXIS 416, *12–13 (May 6, 1985).

equity.²⁴ Additionally, decisional law and scholarship offer no relief from this rule.²⁵ Thus, this provision has been drafted to protect Knox's financial rights in the Series A Preferred Stock to the extent possible. The statutory limitation on this provision will likely cause this provision to be viewed favorably by University because it does not restrict University's issuance of debt to raise capital, except in the case of convertible debt.

III. The Balance Between Series A Preferred Stock Voting Rights and University's Board of Directors' Fiduciary Duties

Although DGCL Section 151(a) grants corporations the authority to determine the voting rights of a series of stock,²⁶ fiduciary duties will restrain University from approving the sweeping supermajority voting rights Knox requested. Knox has expressed interest in a supermajority voting provision that would allow her to vote on all matters presented to University's common stockholders and to possess voting power equal to a supermajority of the common stock votes. There are precedent transactions in Delaware that afford such extensive supermajority voting rights to preferred stockholders.²⁷ However, these provisions are not common and are likely the result of unique, highly negotiated transactions. Such provisions, therefore, do not provide reliable drafting guidance.²⁸

Further, decisional law indicates that such sweeping supermajority voting rights are inconsistent with a board of directors' fiduciary duties because such supermajority voting rights effectively give a single stockholder veto power over all stockholder matters.²⁹ University's common stockholders have a right to vote.³⁰ Therefore, a violation of the common stockholders' voting rights through the board's approval of supermajority voting rights for all common stockholder voting matters would demonstrate a "deliberate disregard of the whole body of

²⁴ DEL. CODE ANN. tit. 8, § 281 (2020).

²⁵ *Warren v. King*, 108 U.S. 389, 400 (1883) (finding preferred stock does not have priority over debt).

²⁶ See DEL. CODE ANN. tit. 8, § 151(a) (2020).

²⁷ *Blockchain Holdings Capital Ventures, Inc.*, *supra* note 22; *Phillips Van Heusen Corp.*, *supra* note 9.

²⁸ Joan MacLeod Heminway, Michael A. Woronoff & Lyman P.Q. Johnson, *Innovative Transactional Pedagogies*, 12 TENN. J. BUS. L. 243, 251 (2011) (discussing the importance of precedent transaction documents).

²⁹ *Lipton v. News Int'l, Plc* 514 A.2d 1075, 1079 (Del. 1986).

³⁰ See tit. 8, § 212.

stockholders,” and would breach the board’s duty of care.³¹ Thus, the exclusion of such a broad voting rights provision should appeal to both parties, as this drafting decision will prevent future litigation about whether the board violated its fiduciary duties to University stockholders by harming the rights of University stockholders.

IV. Minor Drafting Choices

I set the supermajority voting requirement at sixty-six and two-thirds percent because it is one of the more modest supermajority voting percentages I found in decisional law.³² Although Delaware law grants a corporation the authority to determine the voting rights of a series of stock in DGCL Section 151(a),³³ adopting a moderate supermajority voting requirement is a way to convey to University that Knox does not wish to wield unreasonable control, especially if additional shares of Series A Preferred Stock are later issued.

I also decided to format the Certificate of Designations with sub-headers. Some precedent transaction documents used a format similar to that used in the Certificate of Designations below, while others used longer paragraphs without sub-headers.³⁴ I adopted the sub-header format to improve the readability of the provision. This format also made drafting the provision more efficient because it eliminated the need to repeat the leading language of Section 7(b) that applies to the provisions of Sections 7(b)(i) & (ii).

³¹ Lafferty, Schmidt & Wolfe, Jr., *supra* note 14, at 843 (citing *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1982) (“Delaware courts apply a ‘gross negligence’ standard to determine whether a board has satisfied its duty of care when making a corporate decision Delaware courts have defined gross negligence as ‘reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.’” (quoting *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005) (citation omitted))).

³² *Seibert v. Gulton Indus.*, No. 5631, 1979 Del. Ch. LEXIS 485, at *7–8 (June 21, 1979); *Sellers v. Joseph Bancroft & Sons Co.*, 23 Del. Ch. 13, 24 (1938) (holding a supermajority voting requirement of 75% of the preferred stock valid).

³³ See DEL. CODE ANN. tit. 8, § 151(a).

³⁴ *Goldman Sachs Group, Inc.*, *supra* note 9.

RIDER A

CERTIFICATE OF DESIGNATIONS OF SERIES A
CUMULATIVE PERPETUAL PREFERRED STOCK OF
UNIVERSITY, INC.**Section 7. Voting Rights.**

- (a) **General.** Except as provided below, the holders of Series A Preferred Stock have no voting rights.
- (b) **Series A Preferred Stock Voting Rights.** Unless the vote or consent of the holders of a greater number of shares shall then be required by law, the affirmative vote or consent of the holders of at least 66-2/3% of all of the shares of the Series A Preferred Stock at the time outstanding, voting separately as a class, shall be required to authorize:
- (i) **Authorization of Senior Stock.** Any amendment, alteration, or repeal of the Certificate of Incorporation or the Bylaws, whether by merger, consolidation, or otherwise, which will materially and adversely affect the powers, preferences, privileges or rights of the Series A Preferred Stock, taken as a whole; or
 - (ii) **Amendment of Series A Preferred Stock.** Any amendment or alteration of the Certificate of Incorporation to issue, authorize, or increase the amount of, or to issue or authorize any obligation or security convertible into or evidencing the right to purchase, any additional class or series of stock ranking prior to the shares of the Series A Preferred Stock and any Parity Stock as to dividends or the distribution of assets upon liquidation, dissolution or winding up of the Corporation;

provided, however, that for all purposes of this Section 7(b), the following will not be deemed to adversely affect the powers, preferences, privileges or rights of the Series A Preferred Stock: (i) any increase in the amount of the authorized or issued Series A Preferred stock; or (ii) the creation and issuance, or an increase in the authorized or issued amount, of any Parity Stock or any other series of Preferred Stock of the Corporation ranking

junior to the Series A Preferred Stock with respect to the payment of dividends (whether such dividends are cumulative or non-cumulative) and the distribution of assets upon liquidation, dissolution or winding up of the Corporation.

GLOSSARY

- (a) “Board of Directors” means the board of directors of the Corporation, including any duly authorized committee thereof.
- (b) “Bylaws” means the bylaws of the Corporation, as they may be amended from time to time.
- (c) “Certificate of Designations” means this Certificate of Designations relating to the Series A, as it may be amended from time to time.
- (d) “Certificate of Incorporation” means the Certificate of Incorporation of the Corporation, as amended from time to time.
- (e) “Common Stock” means the Corporation’s common stock, par value \$0.01 per share, of the Corporation.
- (f) “Corporation” means University, Inc., a Delaware corporation.
- (g) “Parity Stock” means any class or series of stock of the Corporation (other than Series A) that ranks equally with Series A both in the payment of dividends and in the distribution of assets on any liquidation, dissolution or winding up of the Corporation (in each case without regard to whether dividends accrue on a cumulative or non-cumulative basis).
- (h) “Preferred Stock” means any and all series of preferred stock of the Corporation, including the Series A Preferred Stock.
- (i) “Series A Preferred Stock” means the Corporation’s Series A Cumulative Perpetual Preferred Stock.