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Preferred Stockholders v. Common Stockholders: Who's Really the "Preferred" Stockholder?

In light of recent Delaware case law regarding board of directors' fiduciary duties owed to preferred stockholders and common stockholders in connection with exit transactions, one thing remains clear: Preferred stockholders may get the benefit of their bargain, but when the interests of preferred stockholders diverge from the interests of common stockholders, boards have a duty to prefer the rights of common stockholders.

In *LC Capital Master Fund, Ltd. v. James*, C.A. No. 5214-VCS (Del. Ch. Mar. 8, 2010), the preferred stockholders of QuadraMed Corporation (QuadraMed) sought to enjoin the acquisition of QuadraMed in a cash-out merger, arguing that the QuadraMed Board of Directors breached its fiduciary duties of loyalty and care by failing to consider the value of a liquidation preference and other contractual rights the preferred stock enjoyed in allocating merger consideration. In this case, there was no issue of whether the board had satisfied its Revlon duties to seek the highest price for the company. Rather, relying on well-established precedent, the preferred stockholders argued that the board should have ensured that preferred shareholders received their "fair" allocation of the proceeds of the merger.

Reading the preferred terms set forth in QuadraMed's Certificate of Designations strictly, the court found that the QuadraMed board had acted appropriately in allocating merger consideration to the preferred stock when based solely on a conversion formula written into the preferred terms. Not only did the court find there was no duty to otherwise make a "fair" allocation of the merger consideration to the preferred stockholders, it also stated that the board would be at risk of breaching its fiduciary duties to the common stockholders to the extent it considered rights of the preferred stock that were not triggered by the merger in allocating the merger consideration. The court explained that, although directors do owe fiduciary duties to preferred stockholders, preferred stockholders' rights are largely contractual in nature and are governed by the specific rights and preferences set forth in the certificate of incorporation (including the certificate of designation). Accordingly, the court denied the preferred stockholders' motion to enjoin the acquisition, finding that once the board of directors honored the preferred stockholders' contractual rights it was under no obligation to do more.

LC Capital Master Fund came on the heels of another common stock-friendly outcome in Delaware *In re Trados Incorporated Shareholder Litigation*, C.A. No. 1512-CC (Del. Ch. July 24, 2009). Here, a former common stockholder of Trados Incorporated (Trados) claimed that the

Trados Board of Directors breached its fiduciary duty by approving a merger that provided for the partial payment of the preferred stockholders' liquidation preference and payment of a management bonus plan but left the common stockholders with nothing. The Court of Chancery found that the common stockholders and preferred stockholders had diverging interests with respect to whether to pursue the merger; with the merger, the preferred stockholders would at least receive partial satisfaction of their liquidation preference, but the common stockholders would lose any chance of ever recovering any of their investment. The Court stated that it is generally the duty of the board of directors to prefer the interests of the common stock to the interests of the preferred stock when those interests diverge. Here, plaintiff argued that there appeared to be no pressing need to sell (the preferred stockholders did not have the right to force a sale), that the Company's performance was improving, and that there was a chance that the common stockholders could recover some value. On this basis, and to avoid "the worst possible outcome for the common stockholders," the Court refused to dismiss plaintiff's claims.

Notably, the Court also found that the decision of the board of directors to approve the merger was not entitled to the protection of the business judgment rule because, as is sometimes the case, a majority of the board of directors were interested in the merger transaction as a result of (1) their status as designees of the preferred stockholders and (2) their ownership or employment relationships with certain preferred stockholders.

In the face of conflicting common stockholder interests, what should preferred stockholders do, and what shouldn't they do, to protect their "preferred" status?

WHAT PREFERRED STOCKHOLDERS SHOULD DO:

- Consider all possible exit strategies at the outset of financing negotiations and ensure that the terms are clear on how the preferred stock is treated in each exit strategy.
- Negotiate for certain control rights over the treatment of the preferred stock, including, but not limited to, the following:
 - Voting rights with respect to transactions resulting in the disposition of preferred stock
 - Liquidation preference triggers, including the treatment of mergers and other dispositions of at least a majority of the preferred stock as liquidation events
 - Drag-along rights, including unilaterally-triggered drag-along rights that do not require the board of directors to approve the transaction, or mandatory redemption rights

WHAT PREFERRED STOCKHOLDERS SHOULD NOT DO:

- Rely on the board of directors to accord benefits and/or rights that were not bargained for in the certificate of incorporation.
 - Remember: When the interests of the preferred stockholders and common stockholders diverge, the board of directors has a fiduciary duty to prefer the interests of common stock to those interests created by special rights and preferences—the board of directors may only have a duty to honor the contractual rights of preferred stockholders.
- Rely on the existing makeup of the board of directors in considering exit transactions. Care should be taken to ensure that exit transactions are approved by the requisite number of disinterested directors.

- Remember: The presumption of the business judgment rule is only as good as the independent and good faith judgment that it purports to protect.

For more information or if you have questions regarding the matters discussed in this legal update, please contact [Eric Kogan](#) at (203) 462-7584 or any other member of Robinson & Cole's [Business Transactions Team](#).

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