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What "Mandatory Redemption" Really Means: *SV Investment Partners, LLC v. Thoughtworks, Inc.* - The Importance of Process in Evaluating Preferred Stockholders' Rights

By Laura C. Pieper

Most directors on corporate boards understand the need to act prudently in evaluating corporate decisions. From time to time that process can provide a powerful shield against liability claims against the directors. In a recent decision by the Delaware Court of Chancery in *SV Investment Partners, LLC v. Thoughtworks, Inc*.,[1] the Court highlighted the importance of performing, documenting and following an appropriate process in making board decisions.

In 2000, SV Investment Partners, LLC ("SVIP") purchased 94% of the Series A Preferred Stock in ThoughtWorks, Inc. In August 2006, SVIP sought redemption of its Preferred Stock for $45 million. ThoughtWorks' organizational documents granted holders of the Preferred Stock the right to have their stock redeemed "for cash out of any funds legally available therefor and which have not been designated by the board of directors as necessary to fund the working capital requirements of [Thoughtworks] for the fiscal year of the Redemption Date…."

The ThoughtWorks board of directors considered the extent to which ThoughtWorks had "funds legally available" to make a redemption payment. Freeborn & Peters LLP provided legal advice to the board in connection with the August 2006 meeting and prepared a memorandum to the board setting forth a process to follow in determining whether a redemption payment can be made.

At the August 2006 meeting, the board determined that ThoughtWorks had $500,000 of funds legally available and redeemed Preferred Stock in that amount. Thereafter, in furtherance of this redemption policy, the ThoughtWorks board of directors met each quarter to evaluate (i) whether ThoughtWorks has a surplus from which a redemption could be made, (ii) whether ThoughtWorks had or could readily obtain cash for a redemption, and (iii) whether a redemption would endanger the company's ability to continue as a going concern. The board redeemed Preferred Stock on eight separate occasions with a total value of $4.1 million. However, the board determined in several instances that there were no "funds legally available" to redeem the Preferred Stock.

The Litigation

In February 2007, SVIP filed a lawsuit against ThoughtWorks seeking a declaratory judgment as to the meaning of the phrase "funds legally available" and a judgment for the full amount of the Thoughtworks' redemption obligation or, if less, the full amount of Thoughtworks' "funds legally available." SVIP argued that to the extent ThoughtWorks had "funds legally available, to the extent it had a "surplus" - which merely evidences an excess of net assets over the par value of the corporation's capital stock.

The Opinion

In analyzing the term "funds legally available," the Court noted that the common law has historically restricted a corporation from redeeming its shares when it would be rendered insolvent by the redemption. The Court also cited previous authority that enjoined companies from being a purchaser of its own stock when the payment of the purchase price would result in an injury to its creditors. Due to these other legal restrictions on the use of funds, the Court rejected SVIP's argument that surplus funds and funds that were "legally available" to a company to make a redemption were co-extensive. Instead, the Court stated the definition of "funds legally available" went beyond the definition of "surplus funds," requiring the company to have funds available after the redemption to continue as a going concern.

The Court stressed that even if the "fund legally available language" had not been included in the certificate of incorporation that the limitation on the redemption would necessarily need to be implied to limit a mandatory redemption right. This portion of the ruling effectively expands the applicability of the Court's opinion to *any* company with mandatory redemption rights in its governing documents.

In making its ruling, the Court also praised the ThoughtWorks board's allegiance to quarterly analysis and consideration of the funds legally available for redemption.

> [t]he Board has acted in the utmost good faith and relied on detailed analyses developed by well qualified experts. For sixteen straight quarters, the Board has undertaken a thorough investigation of the amount of funds legally available for redemption, and it has redeemed Preferred Stock accordingly. On each occasion, the Board has consulted with financial and

> legal advisors, received current information about the state of the Company's business, and deliberated over the extent to which funds could be used to redeem the Preferred Stock without threatening the Company's ability to continue as a going concern. The Board's process has been impeccable,[2] and the Board has acted responsibly to fulfill its contractual commitment to the holders of the Preferred Stock despite other compelling business uses for the Company's cash. This is not a case where the Board has had ample cash available for redemptions and simply chose to pursue a contrary course... Most notably, the Board actively tested the market to determine what level of funds ThoughtWorks could obtain. A thorough canvass that included contacts with seventy potential funding sources generated a term sheet that would enable ThoughtWorks to borrow funds netting $23 million for redemptions, *if and only if* the funds were used to satisfy the entire obligation of the Preferred Stock.

This portion of the opinion highlights that following and documenting board procedure when taking actions under the operating documents of your company may be a useful tool in defending challenges to provisions similar to the mandatory redemption provision in ThoughtWorks' certificate of incorporation.

For corporate and LLC governance issues, including redemption rights, please contact Jeff Mattson at 312-360-6312 or Cindy Bergmann at 312-360-6652.

[1]C.A. No. 2724-VCL.
[2]This refers to the process established by Freeborn & Peters in its August 2006 memo.