A CORPORATE AFFAIR EXIT

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In the recent past, the world has seen a sharp rise in the number of start-ups that has entered into various markets, relating to media and communications, medical assistance, technology, plethora of other service sectors. In order for a start-up to fly its business prospects in an economy it requires huge amounts of capital. As a result, in order to complement the growth of start-ups, there has been a rise in the number of private equity (PE) and venture capitalists (VC) in the market. The main purpose of such instruments is to primarily analyse and value the start-up in order to invest in its business. In order to facilitate the investments, it is largely seen that PE and VC players intend to purchase preferred shares of the company. Such an investment technique allows them to liquidate their investment on the occurrence of certain contractually determined events. This article analyses the nature of such preference shares, and argues that such shares oscillate between two different paradigms, vis-à-vis, a corporate and a contractual paradigm.Further, this article analyses the manner in which investors create investor-friendly liquidation preference clauses, that allows the PE and VC players to secure their interests. The article analyses the manner in which preference shares are treated and examined under the Companies Act, 2013 and various FDI policies. Lastly, it is advised and argued that India ought to adopt the clarity in nature of rights of preferred shareholders during a liquidation event which has been provided by two judgements given by the Delaware Courts.

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I. INTRODUCTION

On the fourth of September, 2015, the employees and the shareholders of the Good Technology Corporation, a unicorn start-up company awoke to the sale of the company to Blackberry at $425 million dollars.[1] A few nights later, when the investment documents were circulated, one of employees, frustrated with the acquisition, broke the windows of the one of the conference room windows at the Good Technology‟s headquarters.[2] Such a response was inevitable, since, earlier that year, the company‟s valuation had reached a whopping 1.1 billion U.S. dollars.[3] An obvious consequential question is: what happened to the unicorn start-up that lead to such series of affairs. The answer would be rather simple, what Good Technology experienced was a classic example of the losses the general shareholders and its employees suffer when a company primarily backed by PE or VC investors, goes south.[4]

Good Technology Corporation is a mobile-security start-up company, headed by Ms. Christy Wyatt, the chief executive, which started in 2009.[5] As a unicorn start-up, it has early plans of taking the company public. However, the market‟s interest in mobile management dwindled, and in 2015, it started looking for buyers.[6]The Board of Good Technology was largely controlled by the venture capitalists, who were driven exclusively by self-interest to sell the company.[7] As a result of the waterfall mechanism in such a liquidation event, the preferred

1Ben Dummett, „Blackberry to Buy Good technology for $425 Million‟,The Wall Street Journal, (September 4, 2015).

2Matt Weinberger, „Employees were so angry about Good‟s sale to Blackberry, someone broke a conference room window‟, Business Insider, (December 23, 2015).

3 Ibid.

4Katie Benner, „When a Unicorn Start-Up stumbles, Its Employees Get Hurt‟, The New York Times (December 23, 2015).

5Julia Bort, „A botched acquisition deal, failed IPO, and fire sale pushed Good Technology employees over the edge‟, Business Insider (December 4, 2015).

6 Ibid.

7Stewart Bishop, 'Good Tech Investors Seek to Block $425M Blackberry Deal' (*QLAW 360*, 13 October 2013) <http://www.law360.com/articles/713678/good-tech-investors-seek-to-block-425m-blackberry-deal> accessed 6 May 2016.

stockholders received approximately $250 million, of which $165.4 million were provided to venture capital firms.[8]

The concerned deal manifestly provides an excellent example in which technical draftsmanship by investors are able to create investor-friendly liquidation preference clauses before investing and securing their interest. A liquidation preference determines the manner in which the pie is shared once the company is in liquidation. The Liquidity event should not be misconstrued with winding up, since the term encompasses sale of shares, merger or acquisition of the company or in certain cases in a non-qualified IPO. The paper highlights that the current boost in private equity and venture capital investment in India, the clause of liquidation preferences has become extremely complex. The paper highlights the contractual channel availed by companies in order to receive capital from investors and the manner in which their rights are protected in the liquidity event. The article focuses on various ways in which such clauses in contracts are drafted and manner in which the protection varies depending on the variant stages of the company. Lastly, the paper draws analysis from a duo of Delaware cases, and the manner in which Delaware Courts have dealt with issues relating to the rights of preferred shareholders during a liquidation event.

II. INVESTMENT IN INDIA

The liberalisation of the foreign investment regime in India has allowed foreign investors to invest their capital in Indian companies.[9]Equity funding is a major component in financing the company in order to meet its economic goals. With the advent of sophisticated tools of investment among private equity (PE) or venture capital (VC) investors, the contracts between the companies are complicated and largely protecting the rights of such investors.[10]The most common tool of security for such private equity (PE) or venture capital (VC) investments are preferential shares. As a consequence of purchasing such preferential shares, the investor

8 Ibid.

9 Ved Prakash, „Private Equity Transaction in India", (Works.Bepress, 2009).

10 Study has shown that major start-up companies rely on PE or VC investments to carry on their business. The investors draw noose-tight contracts in order to protect their rights, since they have a higher bargaining power due to the risk taken by them in the course of their investments. Michael Klausner and Stephen Venuto, 'Liquidation Rights and incentive Misalignment in Start-up Financing' [2013] 98(3) Cornell Law Review 1400-1409.

acquires certain preferential rights with respect to payment of dividend and repayment in case of liquidation.[11]

III. LIQUIDATION PREFERENCES

Liquidation preference grants the preferential shareholders the right to receive its initial investment amount with certain additional percentage of proceeds in the event the company goes into liquidation.[12] Such a right allows the investor to recoup the proceeds in the event of liquidation before the common shareholder receives their percentage of takings.[13]The liquidation preference clause in a contract attracts negotiations on behalf of either side, since allows the investor a channel to exit and take a large chunk of the proceeds. The clause acts as a security measure that intends to mitigate the financial risk taken by the PE or VC investor in relation to the common shareholders.[14] A common liquidation preference clause is termed as follows:

"*Upon the occurrence of a Liquidation Event, the entire assets and funds of the Company legally available for distribution shall be distributed in the following manner:*

First Preference

The Investor shall first, be entitled to receive the Preference Subscription Amount plus any arrears of declared and accrued but unpaid dividends calculated to the date of such payment.

Second & Final Preference

11The Companies Act 2013 (18 0f 2013), s. 43 (b) (ii).

12 Nishith Desai Associates, „Liquidation Preference: Get your facts right", The Economic Times (22 July, 2008).

13 Broadly, there are two types of liquidation preference, they are as follows: (I) non-participating liquidation preference, which allows the preference holder will be entitled to receive his predetermined returns, but shall not be entitled to receive any portion of the surplus proceeds to be distributed to the equity shareholders and (ii) participating liquidation preference which allows the the investor, after receiving his pre-determined returns, shall also be entitled to participate (whether fully or to a limited extent) along with the equity shareholders in the distribution of the surplus proceeds. Ibid.

14 Jason M. Gordon and David Orozco, „Trust and Control: The Value of Effect of Venture Capital Term Sheet Provisions as Risk Allocation Tools" [2015] (4) Michigan Business & Entrepreneurial Law Review 222.

After the distributions required to be made under sub-clause (a) above, the balance amounts, if any, remaining shall be distributed in favour of all Shareholders (including the Investor) in proportion to their shareholding on a Fully Diluted Basis."

The common notion attached to liquidation is that it occurs in the event the company is wound up, however, it also comprises of other events such as sale of substantial assets, merger or acquisition of the company.[15]A common clause of liquidation event is termed as follows:

"*For the purposes of this Clause, a "Liquidation Event" shall mean any of the following:*

(a) a liquidation, dissolution or winding-up of the Company including, a compulsory liquidation;

(b) merger or consolidation of the Company in which the Shareholders do not retain a majority of the voting power of the surviving entity;

(c any sale, conveyance, lease or other disposition of 50% or more of the Company's assets and/or stock and/or intellectual property critical to business;".

A mere reading of the liquidation preference clause demonstrates the manner in which the investor through a waterfall mechanism is protected under the broad umbrella of such a clause if the events as enumerated, occur.[16]However, in the event the company is wound up, the distribution of assets are in accordance with sections 326 and 327 of the Companies Act.[17]

During such an event, the distribution of assets cannot adhere to the text of the contract, since the law already provides the order in which the payment of the proceeds are required to paid. According to 326 of the Companies Act, during a winding up of a company, the workmen‟s dues and payment made to secured creditors would be given an overriding preferential payment

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15 "'Liquidation Preference" How Effective is it?' (IndianCorpLaw Blog, 22nd July 2008) <http://indiacorplaw.blogspot.in/search?q=%22Liquidation+Preference%22+> accessed 6 May 2016.

16 Waterfall provisions in an investment agreement provide for the sequence in which different classes of shares have preference. MNK Law Offices, „Liquidation Preference‟ (Mondaq, 18 September, 2014) <http://www.mondaq.com/india/x/341038/Insolvency+Bankruptcy/Liquidation+Preference> accessed 6 May 2016.

17 Under the said section preferential payment is supposed to be provided to first, the workmen‟s dues and then to creditors, and so on and so forth in accordance with the concerned sections.
Companies Act, 2013, s. 326.

over others. [18] Under section 327 of the Act, first payment are required to be made in the following manner:

(i) First towards all revenues, taxes cesses and rates due to the Central or a State Government or a local authority.

(ii) All wages or salaries of an employee.

(iii) All secured holiday remunerations becoming payable to employees on termination of his or her employment.

(iv) All amounts payable to contributions.

(v) All compensations accrued and payable towards workmen‟s‟ under the Workmen‟s Compensation Act, 1923.

(vi) All sums due to any provident funds, pension fund, gratuity fund or any other fund for the welfare of the employees.

(vii) Expenses of any investigation held towards the affairs of the company.[19]

After such payments are made, the Company is required to pay the costs of the liquidator, towards secured creditors, unsecured credit holders, preferential shareholders and lastly, equity shareholders.[20] However, in the event assets are insufficient, they all abate in equal proportion and taxes owed to the Central Government cannot claim a preferential treatment towards other such persons.[21] The concerned sections enumerate the manner in which the Companies Act protects the rights of the employees to receive their fair share of remuneration and the debts owed to secured creditors, over the rights of the investors and other common stockholders.

18Under Section 326 of the Act, such payments are required to be made before any other prior payments during the course of winding up, this section has an overriding effect over all sections contained in the Act. Ibid.

19Ibid s. 327(1).

20 MNK Law Offices, Liquidation Preference, 18 September, 2014, Mondaq, Available at: http://www.mondaq.com/india/x/341038/Insolvency+Bankruptcy/Liquidation+Preference, last visited: 6 May 2016.

21 Baroda Board and Paper Mills Ltd. v ITO, (1976) 102 ITR 153.

However, other than winding up, the Indian Companies Act is largely silent on the manner in which proceeds are distributed in other liquidity events. In such instances, the liquidation preference clause is shifted to the realm of series of negotiation and the terms of the contract. And during such an event, the PE or VC investors rely on technical draftsmanship in order to secure the risk taken by them.

IV. PREFERRED STOCK: CAPITAL OR DEBT

In the Indian context, the holder of a preference share is legally permitted to opt for a contractual channel in order to avail a superior right to receive any payment, ahead of any common shareholders, in the event the company goes into liquidation.[22] This is the foremost reason as to why PE or VC investors rely purchasing preferential shares as a common investment vehicle in investing in high-risk start-ups companies.[23] PE or VC investors often receive convertible preferred stock, [24] which is specifically tailored to provide the investors special rights and preferences. The convertible security may at any point be converted to common stock, and the investor may opt for such conversion in the event it feels that proceeds through common stock may exceed the proceeds through the waterfall mechanism during liquidation event.[25] However, such decisions fall within the ambit of economics and investment decisions and therefore, outside the purview of this article.

Preferential shareholders straddle the line between the realms of corporate law and contract law. In accordance with the corporate paradigm, preferential shareholders are interest holders of the company that intends to maximise the value of the company; whereas, under the contract paradigm, the preferential shareholders intend to allocate risk among the parties and maximize its profits from the investment.[26]The nature of preference shares overlap between two

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22 Josh Lerner and Antoinette Schoar, „Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity" [2005] 120 (1) The Quarterly Journal of Economics 224.

23 W. Bratton and Michael L. Watcher, „A Theory of Preferred Stock", [2013] Working Paper No. 13-3, Pen. L. Sch. For L. & Econ. 892.

24 D. Gordon Smith, „The Exit Structure of Venture Capitals" [2005] 53 UCLA Law Review326-327,.

25 Michael Klausner and Stephen Venuto, Liquidation Rights and incentive Misalignment in Start-up Financing, p. 1400-1415, Vol. 98 Issue 3, Cornell Law Review (2013).

26 W. Bratton and Michael L. Watcher, „A Theory of Preferred Stock" [2013] 161 Pa. L. Rev. 1820.

grundnorms, allowing them to be at conflict with each other.[27] However, it is neither one, and nor the other,[28] it is rather an amalgamation of both, drawing similar structure to that of a debt and an equity.

A. NATURE OF PREFERRED STOCK

Benjamin Graham and David Dodd, in their book, Security Analysis: Principles and Technique, unsatisfactorily concluded that preferential shares have adopted such a nature that reflects the upsides and downsides of both equity and debt.[29]For instance, debt holders of a company is treated outside the purview of the company, with their rights garnered under contractual agreement.[30] They prefer to sit outside the apparatus of the company, bargaining for rights and protection rather than taking an active role in the management and governance of the company. Whereas, equity shareholders are within the apparatus of the company, having statutory rights and obligations. [31] Consequently, it is argued that common shareholders are corporate, and lenders or debt holders are contractual, and they face different legal treatment.[32] However, preferred shareholder straddle this wall that differentiates the two *grundnorms*and as a result forms a hybrid stock.

B. INDIAN CONTEXT: TREATMENT OF PREFERRED STOCK

In the Indian context, there are two kinds of share capital, namely, equity share capital and preference share capital.[33] Equity shareholders have voting rights which allows them vote on every resolution placed before the Company;[34] whereas, preferential shareholders do not have the right to vote on such resolutions unless the resolution place before the company directly effects the rights of the shareholder.[35]Additionally, preferential shareholders have the right to

27 Ibid.

28 LLC v United Artists Theatre Co., 861 A.2d 1251, 1262-64, (Del. 2004).

29 Benjamin Graham and David Dodd, „SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE" (1962) 4th Edition 472.

30 W. Bratton, (n 23) 3.

31 Ibid.

32 W. Bratton,(n 25).

33 Companies Act, 2013, s. 43 (a).

34 Companies Act, 2013, s. 47 (1) (a).

35Companies Act, 2013, s. 47 (2).

receive dividends prior to the equity shareholders.In light of the corporate law apparatus, it does seem that preference shares are somewhat treated as outsiders to the company having no voting rights on integral resolutions placed before the Company.

In the current day investment regime, it is quite common for foreign investors to invest in Indian companies through convertible securities. [36] The common course adopted by such investors is through purchasing convertible debentures or preference shares. Such instruments reflect various characteristics of multiple securities, and are generally considered as hybrid instruments.[37] In the recent past, India has marked its presence in the global economy and has attracted various inbound investments, and such actions are governed by the Foreign Direct Investment (FDI) Policy.[38]T he Consolidated FDI Policy of 2015, has brought certain changes in the FDI policy in order to keep tune with the dynamics of economy and industry.[39]According to the circular, foreign investors purchasing compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares will be considered as equity of the company and would be governed by corporate law.[40] However, other types of debentures or preference shares such as non-convertible, optionally convertible or partially convertible, which has been issued on or after 1st May, 2007, would be considered as debt.[41] Further, such an instrument would fall outside the ambit of corporate laws and would be governed by norms applicable to external commercial borrowing (ECB). [42] The FDI circular further dilutes the understanding of the nature of preferential shares and is suspended between the idea of equity and of debt.

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36 „FDI: Compulsorily Convertible Debentures" (IndianCorpLaw Blog 2009) <Available at: indiacorplaw.blogspot.in/2011/03/changes-to-fdi-policy-part-i.html, last visited>accessed 6 May, 2015.

37 Ibid.

38„Foreign Direct Investment, Make in India" (Make in India) <[http://www.makeinindia.com/policy/foreign-direct-investment>](http://www.makeinindia.com/policy/foreign-direct-investment) accessed 6 May, 2015.

39 „Changes to FDI Policy:-Part I-Convertible Securities", (IndianCorpLaw Blog), <indiacorplaw.blogspot.in/2011/03/changes-to-fdi-policy-part-i.html>accessed 6 May, 2015.

40„Consolidated FDI Policy" Department of Industrial Policy and Promotion Ministry of Governance and Industry Government of India, 12 May 2015.

41 Ibid.

42 Ibid.

It is to be noted that such demarcation of rights and the differential treatment of preferential shareholders are statutorily provided and resultantly guarded by corporate law. However, the edifice of corporate law in India fails to demarcate the preferential treatment of such shareholders in the event of liquidation. The Companies Act of 2013 is largely silent in the manner in which proceeds are to be distributed in a liquidation event, which excludes the event of winding up. Therefore, PE or VC investors resort to technical matters of draftsmanship of their contract in order to receive a preferential treatment.

V. DELAWARE COURTS

A duo of recent decisions of the Delaware Chancery Courts flesh out the core legal issues that surround the legal concept of preferred stock.[43]The decision in each case reveals the manner in which the Courts have relied on theory of both contract and corporate law in order to determine the outcome of the case. Each case provides the manner in which the Courts struggled to apply two different *grundnorms* in order to create a legal structure for preferred stock. The first case, *In re Trados*Case,[44] the Court held that controlling preferred stock holders do hold a fiduciary duty towards the common stockholder, however, such duty could be overcome by the effect of a contract. The second case, *LC Capital Master Fund* Case,[45] the Court held that the preferred rights of an investor is required to be specifically drafted in the contract, and in its absence the Court could not grant any relief to the investors.

A. IN RE TRADOS CASE

In the present case, the matter was brought before the Court by the common stockholders of Trados, a company involved in providing software and services. In 2005, the Board of Directors, which was controlled by the preferred stock holders, sold the company through a merger, and the preferred stockholders (which included venture capital investor) received all the proceeds of the merger under the waterfall mechanism as mentioned and the common stockholders did not receive any payment.[46]The common stockholders argued that the

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43 Charles R. Korsmo, „Venture Capital and Preferred Stock"[2013] 78(4) Brooklyn Law Review 1165.

44In re Trados Inc. S'holder Litig., C.A. No. 1512-VCL, slip op. (Del. Ch. Aug 16, 2013).

45 LC Capital Master Fund, Ltd. v. James, C.A. No. 5214-VCS.

46 Trados (n 44).

Board had a fiduciary duty to favour the interest of common stockholders over the interest of the preferred stockholder.

Chancellor Chandler denied such an argument and stated that the rights attached to preferred stock is wholly contractual in nature. Further, the Court held that in the event the Board is exercising a discretionary judgement, the Board ought to prefer to interest of the common stockholders, as a good faith judgement exercised by the Court.[47] The Court reviewed the transaction of the Board on the anvil of the stringent fairness test that dictates the Board to show fairness of the sale process and transaction terms.[48] The Court went onto hold that the Trados directors had not breached any fiduciary duties since the investor intended to engineer an exit strategy due to the failure of the business and the transaction cost was an appropriate amount paid for the company.[49]

The Court accepted the motivation of venture capitalists to draft liquidation preferences that allow them to take multiples of their investment during a liquidity event due to the high-risk that entails during investment. Further, Chancellor Chandler stated that the Board did not have any contractual obligation towards the preferred stockholders to enter into a merger which ought to be favourable towards such a class. [50] However, the Court tilted in favour of the preferred stockholders and agreed that all sale proceeds would require to be given to the investors since it had been contractually binding on both parties.

B. LC CAPITAL MASTER FUND CASE

In the present case, the matter was brought before the Court by the preferred stock holders, who had purchased convertible preference shares in QuadraMed Corporation. In 2008, the Board decided to initiate a merger. The final merger agreement allowed the preferred stockholders to avail proceeds at a rate which was identical to that of common stockholders.

47 Trados (n 44).

48 David Berger, „Delaware Court of Chancery Upholds Trados Transaction as Entirely Fair"(Harvard Law School Forum on Corporate Governance and Financial Regulation September 3 2016) <https://corpgov.law.harvard.edu/2013/09/03/delaware-court-of-chancery-upholds-trados-transaction-as-entirely-fair/> accessed 6 May, 2016.

49 Trados (n 44).

50 David Berger (n 48).

Aggrieved by the proceeds received, such stockholders argued that they ought to receive the payment at a higher rate as mentioned in their contractual agreement. However, it is pertinent to notice that in their contract with the company, the preferred stockholder failed to include "merger" as a liquidity event and hence, they received such amount that would receive if they had converted their preferred stock into common stock.[51]

The preferred stockholders vehemently argued that the Board owes the preferred stockholders a fiduciary duty to provide fair allocation of liquidation proceeds. Vice Chancellor Stine, denying such a claim, held that the Board must honour only those rights that have been contractually obtained by the preferred stockholder.[52]Further, it was held that to require a Board to provide anything more to the preferred stockholders that what the contract determines would be unfair since, such stockholders did not extract such a right from the contract.[53] Further, Vice Chancellor Stine, citing the *In reTrados* Case, stated that providing the preferred stockholder more than what is provided in their contract would be a violation of fiduciary duty of the Board towards the common stockholders.

VI. ANALYSIS OF THE DELAWARE DECISION

In light of the two decisions highlighted in the present article it is argued that a common stockholder dominated should not have any fiduciary duty towards preferred stockholders and the rights and duties ought to be governed through contract. In an era where private equity or venture capital investor gushes investment in companies, corporate fiduciary duties are unnecessary and such investment should rely on the contractual bargains.[54] It is period where investment through PE or VC has become more sophisticated, with no default in norms of fairness in contracts and the high bargaining power of such investors, such transactions should be vastly be based on the economics of investment as opposed to a legal regulatory framework.

Further, it is noted that great care is required while developing a fairness test in order to protect the rights of the common stockholder. Where the preferred stockholder has secured a contractual right, they should not be prevented to use such a right due to the fiduciary duty

51 LC Capital Master (n
45). 52Ibid.

53 Ibid.

54 Charles R. Korsmo, (n 43) 1228.

owed to the common stockholder. Such a practice would cripple the investment market and deny wealth creation. It is argued that treatment of such core legal issues should be tailored in such a manner that furthers innovation, incentive for PE and VC for further investment and wealth creation as opposed to barricading it by applying legal rules.[55]In India, where there are no regulations under the corporate law regime in case of liquidation preference clauses, it is advised that such leeway should be kept and investors ought to decide what is best suited for their investment. Further, in the event there are core legal issues with regard to nature of preferred stock and the manner in which liquidation preference clauses are to be understood, Indian Courts ought to lay emphasis on the recent two Delaware Court cases for guidance. Lastly, it pertinent to note that great leeway should be provided to investors that have opted a contractual channel to protect their liquidation preference, however, Courts should restrain from allowing such class of stockholders to exercise any right that has not been contractually bargained.

55 W. Bratton and Michael L. Watcher, (n) 1901-1905.