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Effectuation or Alteration? – Court of Chancery Finds Preferred Stock Did Not Have Separate Vote on Automatic Conversion Eliminating the Series

A recent Delaware Court of Chancery case, *Greenmont Capital Partners I, LP v. Mary's Gone Crackers, Inc.*, C.A. No. 7265-VCP (Del. Ch. Sept. 28, 2012), again highlights the contractual nature of preferred stock rights and that, when reviewing whether corporate actions may conflict with any of those rights, the court will generally uphold the independent legal significance of each action taken as it occurs, rather than looking at the ultimate consequence of multiple related corporate actions.

The corporation in *Greenmont* had issued common stock and two series of preferred stock (Series A and Series B Preferred Stock). Under the certificate of incorporation, the Series B holders had a class vote on any action that would “alter or change” the Series B holders’ rights, and any amendment to the certificate of incorporation. The certificate of incorporation also provided that both series of preferred stock would be converted automatically into common stock upon the approval of a majority of the Series A and Series B shares, voting as a single class.

The corporation solicited certain preferred stockholders to vote in favor of the conversion of the preferred stock into common stock, focusing its efforts on certain holders who the corporation knew were more supportive of the conversion. The corporation did not solicit the plaintiff, a substantial Series B stockholder. Holders of a majority of the combined Series A and Series B preferred shares approved the conversion, but holders of less than a majority of the Series B shares voted in favor. Immediately following the conversion of the preferred stock, the corporation’s board amended the certificate of incorporation to remove the provisions relating to the preferred stock.

The plaintiff asserted that, in addition to the combined preferred series vote, the automatic conversion required the separate approval of the holders of a majority of the Series B shares because the conversion “altered” the Series B holders’ rights. The plaintiff also contended that the board’s subsequent amendment of the certificate of incorporation was invalid because the amendment was not approved by holders of a majority of Series B shares.

The court reasoned that, because the automatic conversion provision existed on equal footing with the Series B Preferred’s voting rights, the approval of the automatic conversion in accordance with those voting rights could not “be seen to ‘alter or change’ any of the Series B Preferred’s ‘voting or other powers, preferences, or other special rights, privileges or restrictions.’” Instead, the action merely “effectuate[d] an existing right” under the certificate of incorporation. For the court, “the dispositive question [was] not whether as a *result* of the vote in favor of automatic conversion the Series B Preferred’s rights were altered or changed, but whether the *act* of the vote altered or changed their rights.” Thus, because the challenged action was expressly permitted under the certificate of incorporation and did not alter or change the Series B Preferred’s rights, the court held that no separate approval of the Series B shares was required.

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Addressing the amendment of the certificate of incorporation, the court found that once the automatic conversion had validly occurred, no Series B stock remained outstanding. Though the plaintiff argued that the conversion and the amendment to the certificate of incorporation were “inextricably linked and that the conversion and amendment must be interpreted together,” the court reiterated its fidelity to respecting the order and form of a transaction, noting that the conversion and subsequent amendment were “separate and independent occurrences” each with different legal significance. The court therefore held that, because there were no Series B holders at the time of the subsequent amendment, the Series B holders were not entitled to vote on the amendment to the certificate of incorporation.

The court’s ruling reinforced that Delaware courts will hew closely to traditional contract interpretation principles when reviewing the rights of preferred stock. In particular, the courts will strictly interpret the language of the certificate of incorporation where that language is indisputably clear, harking back to the similar result in *Benchmark Capital Partners IV, L.P. v. Vague* ten years ago where the court found that a series of junior preferred stock did not have a series vote in connection with a merger and financing transaction. Although the court in *Greenmont* acknowledged that the Series B plaintiff’s interpretation of the contract “ma[de] sense,” in light of the fact that the Series A stockholders held a combined majority of the preferred stock (and thus could compel conversion of all the preferred stock on their own) and the plaintiff’s contention that it would not have bargained for such contingent rights, it nevertheless found that the interpretation was “not *reasonable* in light of the indisputably clear language of the [certificate of incorporation].”

Accordingly, careful attention and consideration must be given to the drafting of voting protections and other special rights in preferred stock instruments, because despite rational interpretations to the contrary, only clear and unambiguous terms will be respected.

For the *Greenmont Capital Partners* opinion, see <http://www.paulweiss.com/media/1209038/3oct12dec.pdf>.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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