Stockholder Bears Burden of Proving Breach of Redemption Obligation; Directors Used Best Judgment to Retain Sufficient Resources of The Company

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In Continental Investors Fund, LLC v. TradingScreen, Inc., et al, C.A. No. 10164-VCL (Del. Ch. July 23, 2021), the Delaware Court of Chancery (“Court”) denied plaintiff’s claim for breach of contract, holding that Continental Investors Fund, LLC (“Continental”) failed to carry its burden of proving that TradingScreen, Inc. (“Company”) “acted in bad faith, relied on unreliable methods or data, or reached conclusions so off the mark as to constitute constructive fraud” when calculating the redemption value of Continental’s preferred stock. Further, the Court limited the
interest due calculation to the date on which funds were legally available.

In August 2007, funds managed by Technology Crossover Ventures (the “TCV Funds”) and other sophisticated buyers, including Continental, entered into an agreement with the Company to purchase the preferred stock. The Company adopted a new certificate of incorporation (the “Charter”), which authorized 8,000,000 shares of Preferred Stock. TCV Funds purchased approximately 52% of the shares and Continental purchased approximately 5% of the shares. Section 7 of the Charter spelled out the redemption process, requiring the Company to notify the other stockholders of their right to participate, negotiate with the Majority Holders in good faith to determine the fair market value of the Preferred Stock, jointly select an independent financial advisor to determine the fair market value if an agreement could not be reached, and redeem the tendered shares of Preferred Stock at the price determined after 30 days of the receipt of the financial advisor’s opinion. In anticipation of a situation where the Company might default on its redemption obligation, the Charter provided that if the Company “defaults on any payments . . . interest shall accrue on all amounts then owed . . . equal to an annual percentage rate of thirteen percent (13%).”

In June 2012, the TCV Funds notified the Company that they intended to sell their Preferred Stock, and if they were unsuccessful, they would exercise their redemption rights. Unable to secure a deal, TCV eventually exercised their redemptions in March 2013. Following the procedure outlined in the Charter, the Company provided notice to the other Preferred Stockholders, and Continental elected to participate. The Board established a Committee to facilitate the sale of the Preferred Stock and handle any redemption matters. The Committee consulted with both financial and legal advisors who instructed that the Company was permitted to defer the redemption if it didn’t have “legally sufficient funds” and that the Company could retain a level of cash necessary to maintain its operations when determining the amount of funds available for redemptions. The Company sought debt financing to fund the redemption, but banks were not interested in lending money that would immediately flow out of the Company.

Unable to agree on a redemption price, in February 2014 the Company hired an independent financial advisor who determined that the Company’s fair market value was $120 million, or $16.71 per share. Through the course of several meetings, the Committee evaluated this advice within the context of the Company’s historic cash balance, the views of the Company’s management, and the advice from the Company’s legal and financial advisors, and exercised its business judgment to conclude that the operating expenses would be $20 million, leaving $7.2 million remaining for redemptions.

Following Section 7 of the Charter, the Company began making redemption payments as funds became “legally available.” In September 2014, the shareholders filed suit asserting that the Company failed to use all legally available funds for redemption. Ultimately, TCV Funds and all other holders of the Preferred Stock, except Continental, settled their dispute and accepted the redemption price plus a premium of 23 percent. Continental refused to settle and maintained that the Company breached its redemption obligation.

To establish a breach of a mandatory redemption right in Delaware, Continental bore
the burden of proving that the Company acted in bad faith, relied on methods and data that were unreliable, or made determinations so far off the mark as to constitute actual or constructive fraud. Absent this, a board’s decision regarding the amount of funds available to make redemptions is entitled to deference.

Continental argued that it merely had to “point out that the Company did not redeem all of its shares and pay the full redemption amounts” to prove breach of the redemption obligation under Section 7. Continental then believed that the burden would shift to the Defendants to prove that spending more money on redemptions would render them insolvent. However, the Court relied on Delaware Supreme Court precedent, which holds that the party seeking to enforce the redemption provision has the burden of proof. Continental also argued that the Company had a duty to prove that deploying more funds for redemption would render it insolvent. However, Court again emphasized that burden of proof never shifted to the Company and clarified that a redemption payment rendering a company insolvent was unlawful. The Court further stated that “directors are entitled to (and must) use their judgment to retain sufficient resources to operate for the foreseeable future without the threat of liquidation.”

Continental contended that the Committee used unreliable methods and data to determine the amount of funds for redemptions. The Court, however, concluded that the Committee followed an appropriate process. The Committee took every step outlined in the Charter; they also consulted management, deliberated with reliable financial and legal advisors, and reviewed their historical cash balances to determine the amount of cash needed to maintain the Company’s operations.

Evaluating the evidence, the court dismissed Continental’s argument that the Company acted in bad faith. Under Delaware law, a Company’s board acts in bad faith when “it acts for a purpose other than a genuine attempt to advance the interests of a corporation.” The Committee, however, satisfied their responsibilities, had no intent to violate the law, and subjectively believed they were acting in the best interests of the Company. In addition, the Committee followed each of the steps outlined in the Charter regarding the redemption process and took all the precautions necessary to deliberate and determine the proper amount of redemption funds. The Court found that this was sufficient to show that the Defendants did not act in bad faith.

Finally, the Court addressed whether it was incorrect in holding that Continental was not entitled to the interest that accrued on the redemption amount. The Court was correct in finding that because the Company lacked additional funds to deploy for redemptions in 2014 and 2015, the Company did not breach the Charter, and thus, the interest did not begin to accrue. However, Continental was entitled to interest on the redemption payment made in 2020 because the Company had funds legally available but failed to make payments, thus breaching the Redemption Provision. Once that breach occurred, interest began to accrue at the default 13% rate.


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