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Does Underwater Common Stock Really Have No Value?

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The Delaware Court of Chancery is occasionally asked to determine the value of underwater common stock as part of an appraisal action or breach of fiduciary duty claim. The term "underwater common stock" refers to the situation where the value of a company in a sale is less than the company's debt obligation and the liquidation preference of their preferred stock. This situation occurs most often in venture capital-financed companies that have issued convertible preferred stock for the majority of their capital needs. The liquidation preference of the preferred stock is usually structured so that the preferred stockholders must be paid before the common stockholders receive any consideration in a sale or merger. But the way the Delaware Supreme Court and Court of Chancery have defined the board of directors' fiduciary duties to the common stockholders and described the definition of value has, in some circumstances, left room for underwater common stockholders to claim their shares have value.

The Valuation Framework for Underwater Common

The Delaware Court of Chancery has consistently stated that the duty of the directors is to increase the value of the corporation for the benefit of the common stockholders. The duty owed to the preferred stockholders is primarily contractual in nature. That is, the directors must generally only honor the legal obligations to the preferred stockholders created in the articles of incorporation.[1] A company funded primarily with preferred share offerings usually has a majority of preferred stockholder designees on the board of directors. The preferred stockholders have negotiated and paid for this right to help monitor, manage and increase the value of their investment. But within the Delaware legal framework, the preferred stockholder director designees cannot perform that role without regard to the fiduciary duties owed to the common stockholders.

The court has also been clear that valuation experts in an appraisal or breach of fiduciary duty claim must determine the value of the common stock before the merger or sale, without regard to any synergies related to the sale, considering what has been taken from the common stockholder, i.e., his or her pro-rata share of a going concern. And it is this going-concern premise, in combination with the duties owed to the common shareholders, which opens a window of opportunity for the underwater common stockholders. Because even when common stock is underwater, it often trades between investors at positive values based on the possibility that the company's fortunes will improve in the future.

Delaware Court of Chancery Underwater Common Stock Case Review

There have only been a few cases in Delaware that have addressed the valuation of underwater common stock. When the court turned to the valuation evidence in these cases, traditional valuation methods, such as the discounted cash flow method, the comparable public company multiple method, and the comparable transaction multiple method were used. In the most recent case (Trados),[2] the court demonstrated an evolving appreciation for the additional analysis required when valuing underwater common stock in a going concern.

Orban v. Field

Orban was one of the first cases to address the underwater common stock value issue.[3] In the case, the holders of the preferred stock controlled the board and facilitated steps before a sale transaction to reduce the founder's common stock interest below 10 percent, which would allow the acquisition to be completed. Staples Inc., the acquirer, required 90 percent of each share class to approve the acquisition so that it could qualify for pooling of interest accounting. The founder of the target (Office Mart Holdings Corp. or Office Mart), Orban, asserted that the board breached its fiduciary duty of loyalty to him by causing the dilution of his interest below 10 percent. Before a recent recapitalization, Orban held just over 10 percent of the common shares and tried to use the class vote requirement as leverage to extract some consideration from the transaction.

At the time of the Staples offer in February 1992, the liquidation preference of the all the preferred stock was approximately $35.1 million and the all-stock offer was $35 million, leaving nothing for the common stockholders. Office Mart was a private company and throughout its history, the company had repeatedly sought preferred and debt funding to operate, although at the time of the Staples offer, Office Mart had $6 million in cash.

The court ruled that the board had not breached its duty of loyalty to Orban because the board was simply satisfying its legal obligations to the preferred stockholders required as a result of the recapitalization. In satisfying those contractual requirements, the board was conducting itself in the appropriate manner. Although Orban didn't address specifically the valuation issues regarding underwater common stock, it is instructive that the Delaware courts will recognize the contractual obligations of the board to the preferred stockholders even if those obligations are harmful to the common stockholders.

Oliver v. Boston University

Seragen Inc. was a development-stage biotechnology company that had its initial public offering in 1992. After a series of debt and preferred stock offerings in which the company was on the edge of bankruptcy and threatened with delisting from Nasdaq, the company was purchased by Ligand Pharmaceuticals Inc. in August 1998. Certain common shareholders filed suit alleging several breaches of fiduciary duty against the conflicted board for several financing transactions and the allocation of the merger consideration.[4] The board was made up of representatives and affiliates of Boston University, as well as senior Seragen management. Boston University held the majority of the preferred stock and also had other senior claims on the transaction consideration.

The merger consideration consisted of $30 million paid at closing and a further $37 million in contingent consideration. Ligand conditioned the close of the transaction on less than 10 percent of the common shares presenting themselves for appraisal. Seragen had numerous claims on the merger consideration that were greater than the $30 million of initial consideration. However, because the noncommon stakeholders needed to reduce the common shareholders that presented their shares for appraisal below the 10 percent threshold, they allocated 50 cents per share of the initial $30 million consideration to the common stockholders. The common stock was trading at 40 cents one month prior to the transaction announcement and had a common stock market capitalization of $11.2 million.

The court in Oliver ultimately found that the board had breached their duties with respect to the merger allocation, even though they had discounted what they believed Seragen was obligated to pay them. In describing the allocation, the court said “the process implementing these negotiations was severely flawed and no person acted to protect the interests of the minority common shareholders.” The court found the common stock suffered actual damages of $4.8 million and nominal damages of $1. Similar to Orban, Oliver was not particularly helpful with regard to the valuation of underwater common stock in general as it focused on damages caused by the board in allocating the transaction consideration.

In re Hanover Direct Inc. Shareholders Litigation

The Hanover case involved an April 2007 going-private transaction where Chelsey Direct LLC purchased the remaining 31 percent of the common shares of Hanover Direct Inc. it did not already own for 25 cents per share.[5] Hanover’s shares were thinly traded on the Pink Sheets, and the company had no analyst coverage. Hanover’s board members were all either affiliates of Chelsey or expected to be employed by Chelsey after the transaction.

Hanover was burdened with significant debt and a series C participating preferred. The preferred and the debt together comprised $92.7 million of securities senior to the common stock. Despite all the senior obligations, the common shares traded at $1.25 per share just one month prior to the transaction announcement and had a common stock market capitalization of $28 million.

The board of directors hired an independent valuation adviser, Agio, but did not establish an independent committee. Agio opined that the enterprise value of Hanover was between $72.5 and $79 million, materially below the total debt and preferred stock liquidation preference. Agio did not believe the common stock price was an indicator of the value of Hanover and stated the common stock was trading on a “speculative, as opposed to an economic basis.” It should be noted that Hanover, although not generating positive income for common shareholders, was not immediately facing insolvency.

In the decision, the court relied upon the respondent’s expert report that was found to be “accurate, reliable, and reflective of a per-share value of the company below $0.00.” The respondent’s expert used traditional valuation methods to determine the enterprise value of Hanover, including a discounted cash flow analysis, a comparable companies analysis and a comparable transactions analysis. The court found the merger price of 25 cents entirely fair and, based on the tone and content of the opinion, likely would have found no consideration to the common stockholders fair as well.

In re Trados Inc. Shareholder Litigation

Trados is the most recent and thoughtful opinion addressing the valuation of underwater common stock.[6] The case dealt with a private company, Trados Inc., which was founded in 1984 and received its first round of venture capital funding in 2000. The company completed numerous rounds of preferred financing through 2002, accumulating a significant liquidation preference. All the preferred stock issued carried an 8 percent accumulating dividend payable upon a sale. The board of directors was controlled by the preferred stock investors and senior company management.

In July 2004, Trados hired a new CEO who had a positive impact on revenue growth and profitability. At the same time, the board was in discussions with several potential buyers of the company and contemplating a sale. As part of the compensation package to attract the new CEO, the company implemented a management incentive plan (MIP) that allocated a percentage of sale consideration to senior management.

Ultimately, Trados was sold to SDL PLC on June 15, 2005, for $60 million. The MIP took the first $7.8 million of consideration and the preferred stock (liquidation preference of $57.9 million) took the balance of $52.2 million, leaving nothing for the common shareholders. Certain common shareholders sought an appraisal of their shares and, upon discovery in the appraisal action, filed a second lawsuit alleging the board of Trados breached its duty of loyalty by approving the merger.

In the thoughtful opinion, the court clearly differentiates the value of the common stock in a going concern versus the value within the context of the SDL transaction. Ultimately though, even with Trados generating positive cash flow and holding $3.3 million in cash, the court decided the common stock was worthless and could not reasonably expect to escape the "gravitational pull of the large liquidation preference and the cumulative dividend."

Court Case Review Conclusions

The review of Delaware cases reveals no definitive conclusion with regard to whether underwater common stock has value in an appraisal claim or a fair-price lawsuit. Two of the cases concluded that no consideration was fair (Orban and Trados) and two cases ascribed some value to the common shares (Oliver and Hanover).[7] Two interesting patterns emerge though: 1) both cases involving publicly traded companies (Oliver and Hanover) allocated some consideration to the common shares, and perhaps more significant to the valuation of underwater common stock in a going concern, 2) both companies in Oliver and Hanover (Seragen and Hanover) had common shares that traded at a material value before the transaction announcement.

Are Private and Publicly Traded Companies Valued Differently in the Delaware Courts?

A casual observer of the underwater common cases might assume the difference in value is attributable to the private companies' lack of a liquid market for their shares. But the Delaware valuation framework is clear that no marketability discounts should be ascribed to a private company's common stock in either a fair-price or fair-value determination. A casual observer might also believe that different methods were applied to the private companies than were applied to the publicly traded companies. In Hanover and Trados, the two cases that discuss the expert opinions in some detail, plaintiff and respondent experts all use either a discounted cash flow analysis, comparable public company analysis or comparable transaction analysis, with no apparent regard for the public or private status of the company.

In fact, what the case review reveals is that investors apply a different valuation methodology for underwater common stock than was used in the cases. Public investors bought the shares of Seragen and Hanover based on an estimated probability they would have a positive value estimated using traditional valuation methods at some point in the future. This type of value isn't captured by the traditional valuation methods used historically in fair-value and fair-price disputes in Delaware, and is often referred to as "option value." It doesn't appear that any of the valuation experts in the underwater common stock cases attempted to determine the option value of the common stock.

Of course, since the review included only two cases of publicly traded shares trading at a positive value before a transaction, the pattern could have occurred by chance as well. To verify whether this pattern was an anomaly in the small number of cases available, or rather, an economic reality, I examined the common shares of publicly traded companies one month prior to a Chapter 11 bankruptcy announcement for the previous 12 months to determine whether the common stock had any value. My research revealed that even in very highly leveraged companies that have negative earnings, the common shares all still traded at positive values. On average, the common stock made up about 5 percent of the enterprise value of the company, with net debt (total debt less cash), making up the other 95 percent. These results add further support to the proposition that underwater common stock is valued using a different model than the models used in the Delaware courts.

To those trained in finance and company valuation, this comes as no surprise. Finance professionals have been using models that recognize option value in common shares for decades. Some securities, like underwater common stock, can only be accurately valued using a model that recognizes option value. In fact, Robert Merton postulated in the 1970s that all common stock could be viewed as a call option on the total firm value in a leveraged company.[8] In his seminal paper on the pricing of corporate debt, Merton demonstrated that levered common equity in a corporation has an isomorphic relationship to a European call option.[9] The valuation of call options was first achieved from observable inputs in the previous year by Fisher Black and Myron Scholes.[10] Merton's simple model of a company financed with a single zero-coupon debt issue led to the creation of more sophisticated models that lend themselves to the valuation of numerous classes of equity in companies with many senior claims.

One of the most commonly applied models used today that recognizes option value is called the option pricing method (OPM). The OPM first came into wide use following its description in the 2004 American Institute of Certified Public Accountants (AICPA) practice aid used to value common stock in venture capital-funded companies.[11] The OPM values the common equity using a going-concern premise, not under a current liquidation or transaction scenario. Because of this quality, the OPM also lends itself to the valuation of underwater common stock in fair-price and fair-value actions in the Delaware courts.

Considerations When Valuing Underwater Common Stock Using Option Methods

Not unlike the traditional valuation models used in the Delaware courts, the OPM requires a number of inputs. Like all model inputs, they can be influenced by expert bias. But also like all model inputs, they are subject to verification with market evidence, analysis and judgment.

Investment Time Horizon

One of the most important considerations when applying a model that recognizes option value is estimating the investment time horizon of the common stock. In all the Delaware cases reviewed, the common stockholders were not able to control the timing of the company sale. But within a fair-price or fair-value framework, where the expert is to consider what has been taken from the underwater common shareholder, the correct measure of the investment time horizon is likely how long the company can remain solvent without regard to the transaction at issue. Considerations include the availability of financing, the level of profitability and the existence of any excess assets, among others. In many of the Delaware cases reviewed, the companies were in dire need of cash, and perhaps only Trados could have continued to operate for any meaningful time period. Often, the estimated time horizon will be quite short, perhaps a matter of weeks or months, which has the effect of reducing the common stock value. Of course, in making the investment time horizon determination, all information, including information not publicly available, needs to be considered.

The Amount of the Senior Claims Versus the Enterprise Value

Other key inputs will be the amount of the claims senior to the common stock and the current enterprise value of the company. Logically, the more underwater the common stock is, the less value it has. Obviously, senior claims would include the preferred stock's liquidation preference. But the liquidation preference is estimated at the end of the investment time horizon in the OPM, so should include accruing dividends, if appropriate. A high dividend yield on the liquidation preference of the preferred stock can materially impair the value of underwater common shares. Other senior claims can also include debt instruments, but these are often more accurately valued using yield-based methods outside of the OPM. As Trados highlighted, a management incentive plan can also impact the payoff of the common shares and needs to be considered. In circumstances where transaction expenses (e.g., investment banker and legal fees) are paid with sale proceeds, they should be included as a senior claim as well. Finally, if funds are placed in escrow, and there is less than 100 percent certainty they will be released in full, the impact needs to be factored into the model inputs.

Other Considerations

The OPM has other inputs, such as the risk-free rate and the expected volatility of the company's equity or enterprise value. The volatility input is often the most contentious, but there is observable information in the market and the Delaware courts have shown the ability to select the appropriate inputs for financial models in the past (e.g., betas for developing discount rates using the capital asset pricing model).[12]

Final Thoughts

Valuation estimates that are speculative in nature are generally not viewed positively in the Delaware courts. For example, forecasts that are speculative are often discarded or underweighted in valuation disputes.[13] This treatment is appropriate when selecting a forecast that will use a discount rate that reflects reasonable expectations of future performance.

But the valuation of underwater common stock using option models requires accepting that unexpected positive and negative corporate results can and do occur. Option models don't estimate a 100 percent probability of a positive event occurring (i.e., the enterprise value exceeding the senior claims). The models rationally measure the likelihood of that event based upon the time horizon, the extent of the senior claims, the current enterprise value and the volatility of the company's business, and make an unbiased economic assessment. Investors in companies on the brink of bankruptcy are certainly making a high-risk investment, but they consider that risk by the amount they are willing to pay for the common shares. That investors are willing to invest their hard-earned dollars in the underwater common stock of many companies is pervasive market evidence that option value exists.

Even using option models however, the amount of value attributable to common stockholders in underwater common is likely to be small relative to the value of the entire enterprise. Whether this amount is sufficient for the Delaware courts to recognize it within the fair-price and fair-value framework remains to be seen. It would seem though, that for the common stockholders, relative to nothing, almost anything is material.

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[1] Judah v. Del. Trust Co., 378 A.2d 624, 628 (Del. 1977).

[2] In re Trados Incorporated Shareholder Litigation, 73 A.3d 17, 37 (Del. Ch. 2013).

[3] Orban v. Field, C.A. No. 12820, 1997 Del. Ch. LEXIS 48 (Del. Ch. Apr. 1, 1997).

[4] Oliver v. Boston University, C.A. No. 16570, 2006 Del. Ch. LEXIS 75, at *1-*2 (Del. Ch. Apr. 14, 2006).

[5] In re Hanover Direct, Inc. S'holders Litig. Consol. C.A. No. 1969-CC; Fackelmayer, et al. & Cede & Co. v. Hanover Direct, Inc., Civil Action No. 3047-CC; and Fackelmayer, et al. v. Feldman, et al., C. A. No. 3291-CC, at *1 (Del. Ch., Sept. 24, 2010).

[6] Trados, 73 A.3d.

[7] Although, one could make an argument that the Court in Hanover would likely have concluded zero consideration for the common was also fair.

[8] R.C. Merton, On the Pricing of Corporate Debt: The Risk Structure of Interest Rates, 29 J. Finance, 449 (1974).

[9] A European call option gives the owner the right, not the obligation, to purchase a common share at a specified price at the end of its term.

[10] F.Black & M. Scholes, The Pricing of Options and Corporate Liabilities, 81 No. 3 J. Pol. Econ., 637 (1973).

[11] AICPA Audit and Accounting Practice Aid, Valuation of Privately-Held-Company Equity Securities Issued as Compensation, (2004). (The Practice Aid was updated in 2013.)

[12] E.g., Merion Capital, L.P., v. 3M Cogent, Inc., C.A. No. 6247, at *40-*45 (Del Ch. July 8, 2013).

[13] E.g., Gearreald v Just Care, C.A. No. 5233, at *14 (Del Ch. April 30, 2012).
