

Special Report of the TriBar Opinion Committee: Duly Authorized Opinions on Preferred Stock

By the TriBar Opinion Committee*

Purchasers of newly-issued shares of preferred stock typically seek an opinion from the Company's counsel that the shares have been duly authorized and validly issued and are fully paid and nonassessable.¹ This report amplifies the discussion in § 6.2.1 of the 1998 TriBar Report of the meaning of the "duly authorized" part of this opinion when it is given on preferred stock.

An opinion that the shares of preferred stock have been "duly authorized" is understood as a matter of customary practice to mean that, in the professional judgment of the opinion giver:²

- the shares are part of a class or series of shares that the Company has the authority to issue—i.e., are part of the authorized capital stock of the Company;
- when the shares were issued, the Company had a sufficient number of authorized shares of that class or series available for issuance;³

* The TriBar Opinion Committee (the "Committee" or "TriBar") currently includes designees of the following organizations functioning as a single Committee: (i) Special Committee on Legal Opinions in Commercial Transactions, New York County Lawyers' Association; (ii) Corporation Law Committee, The Association of the Bar of the City of New York, and (iii) Special Committee on Legal Opinions of the Business Law Section, New York State Bar Association. Members of the state bars of California, Delaware, Georgia, North Carolina, Pennsylvania and Texas and of the Allegheny County (Pittsburgh, PA), Atlanta, Boston, Chicago, District of Columbia and Toronto, Ontario Bar Associations are also members of the Committee. The members of the Committee and the Reporter and Drafting Group for this Report are listed in Appendix A.

This Report has not been approved by the governing body or membership of any of the bar associations whose committees or members were involved in its preparation. Accordingly, the views expressed are solely those of TriBar. This Report reflects a consensus of the Committee. It does not, however, necessarily reflect the views of individual members or their firms, organizations, or associations on any particular point.

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1. This opinion also sometimes is given on previously issued shares of stock of the Company. For example, it may be given to underwriters in a Company's initial public offering or to stock exchanges in connection with listing the shares. See TriBar Opinion Committee, *Third-Party Closing Opinions: A Report of the TriBar Opinion Committee*, 53 Bus. Law. 591 (1998) ("1998 TriBar Report") § 6.2.5.

2. Certain of these conclusions also must be reached to give the "validly issued" part of the opinion and, thus, that opinion cannot be given if the "duly authorized" opinion cannot be given. When the preferred stock is convertible into other shares, such as common stock, the opinion recipient often will request an opinion on those shares as well.

3. In determining whether a sufficient number of authorized shares are available for issuance, the opinion preparers would have to take into account shares that have been "committed" to be issued

- the proper procedural steps were taken to create the class or series of shares,⁴ including, if an amendment to the charter is required,⁵ approval of the amendment by the board of directors and/or the stockholders by the requisite vote of each class or series entitled to vote,⁶ as may be required by the applicable state corporation statute,⁷ and the filing of the amendment in the proper form with appropriate state officials;⁸
- the Company's charter contains all the substantive terms, for example, par value, number of authorized shares and preferences, required by the applicable state corporation statute to create the class or series of preferred stock;⁹ and

under a state corporation statute such as § 161 of the Delaware General Corporation Law ("DGCL"). That would include additional shares the issuer has become committed to issue as a result of triggering antidilution provisions in outstanding securities.

4. The Delaware Chancery Court has commented as follows on the importance of a corporation's observing the formalities for creating stock:

Several policy reasons that justify the need for such formality readily come to mind. . . . Given the foundational importance of [corporate] securities in our economic system, it is critical that the validity of those securities, especially those that are widely traded, not be easily or capriciously called into question. Otherwise, the resulting economic uncertainty to investors and institutions that relied upon the integrity of those securities would be destabilizing. Accordingly, our statutory scheme, elucidated by case law, has developed a clear and easily followed legal roadmap for creating these valuable instruments that represent claims upon the enterprise's capital. Under that model, if that roadmap is followed, the investment community will be assured that the corporate securities created by that process will not be vulnerable to legal attack. If, on the other hand, it is not followed, then the securities will become subject to possible invalidation.

Kalageorgi v. Victor Kamkin, Inc., 750 A.2d 531, 538 (Del. Ch. 1999), *aff'd*, 748 A.2d 913 (Del. 2000) (TABLE); *see also Triplex Shoe Co. v. Rice & Hutchings*, 152 A. 342 (Del. 1930).

5. References to the charter mean the document that the applicable state corporation statute requires be filed with state authorities, typically the Secretary of State, to incorporate the corporation. It is called a certificate of incorporation in the DGCL and articles of incorporation in the Model Business Corporation Act.

6. Stockholder approval would not be necessary if the board, pursuant to a provision in the charter authorized by the state corporation statute, has so-called "blank check" authority to create the class or series of shares and establish its terms. When the director or shareholder actions being relied on took place some time ago, the opinion preparers may find the "presumption of regularity" helpful in giving the opinion. *See* 1998 TriBar Report § 2.4.

7. References to the applicable state corporation statute mean the statute as interpreted by the courts, as well as any applicable state constitutional provisions. For example, Delaware had a constitutional provision dealing with consideration to be received for par value stock before its repeal in 2004. *See* 1998 TriBar Report notes 126 and 137.

8. Ordinarily, if the board uses its blank check authority to create the class or series, a charter amendment, referred to as a certificate of designation in some states, must be filed with designated officials (typically the Secretary of State) and upon filing becomes part of the charter. *See Liebermann v. Frangiosa*, 844 A.2d 992 (Del. Ch. 2002). The requirements for a charter amendment to be "filed" are governed by the state corporation statute; for example, in some states filing does not occur until a document is accepted by the designated state official.

9. In some states, preferred stock must have a preference in liquidation or the payment of dividends or, depending on the statute, both. *See* § 501(b) of the New York Business Corporation Law; *Telvest, Inc. v. Olson*, 1979 Del. Ch. LEXIS 347 (Del. Ch. Mar. 8, 1979); *Starring v. American Hair & Felt Co.*, 191 A. 887 (Del. Ch. 1937); *see also Shintom Co. v. Audiovox Corp.*, 2005 WL 1138740, at *3, n.7 (Del. Ch. May 4, 2005) ("the preferred stockholders must have some preferred right over the common, otherwise the stock is considered illusory"), *aff'd*, 888 A.2d 225 (Del. 2005).

- the Company has the power under the applicable state corporation statute and its charter to create stock having the rights, powers and preferences of the stock in question.¹⁰

The first four bullet points above are relatively straightforward. The fifth bullet point merits amplification because of uncertainty over whether the duly authorized opinion covers not only the issues addressed by the first four bullet points but also substantive issues addressed by the fifth bullet point.¹¹

The starting point for the analysis called for by the fifth bullet point is the applicable state corporation statute.¹² Modern corporation statutes typically grant corporations the authority to create preferred stock having such terms as they may desire, subject only to compliance with the requirements of that statute¹³ and the requirements, if any, of the corporation's charter. A duly authorized opinion is understood as a matter of customary practice to confirm that the Company has the power to create stock with the rights, powers and preferences of the preferred stock in question. Since most corporation statutes contain broad statutory authority to create and issue stock with whatever economic and other terms a corporation chooses,¹⁴ an opinion preparer's inquiry regarding this point often

10. See *Waggoner v. Laster*, 581 A.2d 1127 (Del. 1990) (holding that stock created pursuant to the board's blank check authority was void because the blank check authority did not authorize the creation of preferred stock with supermajority voting rights).

11. This uncertainty may have existed because, when giving a due authorization opinion on an agreement, the opinion preparers principally focus on whether the agreement received all the necessary procedural approvals (although, as in the case of a contract to engage in an unlawful activity or an activity not within the company's corporate power, they also must consider whether the company has the power to enter into the agreement). Opinions on the due authorization of agreements are discussed in 1998 TriBar Report § 6.4.

12. The applicable state corporation statute may be the statute of the state in which the opinion preparers practice or it may be the statute of another state, such as Delaware. Non-Delaware lawyers are usually willing to give the duly authorized opinion on preferred stock issued by Delaware corporations when difficult issues are not presented. Ordinarily, opinions on Delaware corporate law given by non-Delaware lawyers are expressly limited to the DGCL. See note 7 *supra*.

In some states, regulated companies, such as public utilities, are incorporated under the general corporation statute but are subject to a separate regulatory statute of that state that limits the stock they may have or the terms of that stock or require that changes in the stock receive regulatory approval. In those limited cases, in giving the duly authorized opinion, the opinion preparers should consider the limitation or requirement for regulatory approval under the regulatory statute (even when the opinion is expressly limited to the applicable corporation statute) unless the regulatory statute is excluded from the opinion's coverage. See 1998 TriBar Report § 6.2.2 (indicating, in the context of the "validly issued" opinion, that these statutory provisions are treated, as a matter of customary usage, as though they appeared in the corporation statute).

13. The applicable corporation statute may require, for example, that all holders of shares of a class, if the class is not divided into series, and of a series if the class is so divided, have the same rights, powers and preferences.

14. In interpreting corporation statutes, courts usually are reluctant to impose limitations on a corporation's power that are not set forth expressly in the statute. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985) ("[m]erely because the General Corporation Law is silent as to a specific matter does not mean that it is prohibited"); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985) (holding in absence of affirmative evidence that the legislature intended to limit Section 157 of the DGCL to the issuance of rights for the purpose of a corporate financing, "we decline to impose such a limitation upon the section that the legislature has not"). See also *Hildreth v. Castle Dental Centers, Inc.*,

will be limited to whether any of the specified rights, powers or preferences of the preferred stock violate provisions of the corporation statute or the Company's charter.¹⁵ Such a violation might exist, for example, if the preferred stock purports to deny holders voting rights, appraisal rights or inspection rights¹⁶ mandated by the statute. Similarly, such a violation might exist if the preferred stock purports to deny holders voting rights when the charter prohibits non-voting stock or to grant a new class or series priority in liquidation over an existing class or series whose terms prohibit creation of stock with a higher priority. The economic terms of preferred stock, such as liquidation preferences or antidilution clauses, ordinarily do not violate the corporation statute and thus, as long as those terms do not violate the charter, usually do not require an exception.¹⁷

The duly authorized opinion does not address limitations that derive from sources other than the state corporation statute¹⁸ or the Company's charter, such as other statutes and cases that do not arise under the corporation statute.¹⁹

Opinion recipients sometimes request that the opinion expressly confirm that the terms of the preferred stock do not violate the state corporation statute and the Company's charter. One formulation opinion preparers sometimes use for this confirmation is:

The rights, powers and preferences of the preferred stock set forth in the [charter] do not violate [the applicable corporation statute] or the [charter].

The Committee believes, as indicated above, that this confirmation is already encompassed within the duly authorized opinion.²⁰

939 A2d 1281 (Del. 2007) (rejecting claim that preferred stock was void because there was insufficient authorized common stock to permit exercise of conversion rights in full).

15. Although "no violation of law" and "no breach or default" opinions might cover the conclusions that the preferred stock provisions do not violate the corporation statute or the Company's charter (see 1998 TriBar Report §§ 6.5 and 6.6), the "duly authorized" opinion addresses those points directly.

16. See *Loew's Theatres, Inc. v. Commercial Credit Co.*, 243 A2d 78 (Del. 1968) (charter provision eliminating inspection rights was void).

17. Even if the opinion preparers are able to conclude that the board had the legal authority to create the stock in question, an issue could still exist as to whether the board, in exercising its authority, discharged its fiduciary duties. Cf. *Sample v. Morgan*, 914 A2d 647, 663-64 (Del. Ch. 2007) (distinguishing between board's having legal authority and its exercising that authority "consistently with equitable principles of fiduciary duty"). As a matter of customary practice, opinion preparers can assume without so stating that fiduciary duties have been satisfied unless under the circumstances that assumption is unreliable. See 1998 TriBar Report §§ 3.5.2(b) and 6.4. Compliance with fiduciary duties might, for example, be an issue, depending on the circumstances, when a corporation engages in a so-called "down round" financing in which the board of directors creates a new class or series of preferred stock for sale to investors that include affiliates of the directors at a price below that of the previous round. In those circumstances, the opinion preparers should consider the need to exclude compliance with fiduciary duties expressly from the opinion's coverage, assume such compliance expressly or, in some cases, decline to give the opinion at all.

18. See note 12 *supra* with respect to coverage of certain regulatory statutes.

19. Although limitations deriving from other sources are not covered by the duly authorized opinion, if the opinion preparers recognize that the creation of a class or series of stock would be prohibited by such a limitation, they should consider whether disclosure is required to avoid misleading the opinion recipient or, indeed, whether to deliver the opinion at all. See 1998 TriBar Report § 1.4(d).

20. A duly authorized opinion on preferred stock does not address provisions relating to the preferred stock that are contained in a separate agreement between the parties but that are not set forth in the charter, even if those provisions could have been included in the charter.

The duly authorized opinion does not cover a stockholder's ability to enforce the provisions of the preferred stock.²¹ Rather, the opinion looks only to the Company's power under the applicable corporation statute and the Company's charter to create the class or series of preferred stock in question. Thus, like an opinion that a company has the corporate power to enter into and perform an agreement, an opinion that preferred stock has been duly authorized does not address the question whether the terms of the preferred stock (assuming the Company has the power to create them) will be given effect by the courts in a particular instance.²²

Occasionally, an opinion recipient requests an opinion that the provisions of the preferred stock (or certain of the provisions) are "enforceable in accordance with their terms." Opinion givers normally are unwilling to give this opinion with respect to preferred stock, either generally or on specific provisions. This is because an opinion on the enforceability of an agreement addresses contract law concepts (and includes the standard exceptions²³) and preferred stock provisions are not governed by contract law but rather by corporation law.²⁴ As one court has put it, unlike a holder of debt, a holder of preferred stock does not have "a legally enforceable right to payment."²⁵ Thus, the concepts underlying an enforceability opinion do not easily fit.

When preferred stock provisions are relatively straightforward, opinion preparers usually have little difficulty giving an unqualified duly authorized opinion. When preferred stock provisions are more complex (as they have become in recent years in some private transactions), opinion preparers may have more difficulty giving an unqualified opinion. If opinion preparers are unable to conclude

21. The Committee recommends that opinion givers avoid giving an opinion that "the rights, powers and preferences of the preferred stock are as set forth in the charter." Besides failing to cover rights granted by the applicable corporation statute, such an opinion might be read as confirming the enforceability of those rights, powers and preferences even though that may not be the intended meaning.

22. Nor, as noted in the 1998 TriBar Report § 6.2.1, does the duly authorized opinion cover compliance with disclosure requirements of state and federal securities laws in soliciting any required stockholder approval of the charter amendment creating the preferred stock.

23. The standard exceptions to a remedies opinion on an agreement are the bankruptcy exception and the equitable principles limitation, which are understood to be applicable whether stated or not. See 1998 TriBar Report § 3.3.

24. Corporation law limits the "promise" created by preferred stock. Thus preferred stock provisions cannot commit a corporation to pay amounts to preferred stockholders but can only set priorities on how any available funds may be distributed to stockholders. Dividend payments under a traditional "when, as and if declared" dividend provision are subject to the discretion of the board of directors exercising business judgment and such provision does not create an enforceable "promise." Even if dividends are styled as "mandatory," state corporation law generally requires that lawful funds be available (and imposes liability on directors for approving unlawful dividends) and that the dividends be declared by the board of directors (although a director may have liability for failing to declare a mandatory dividend when the corporation has lawful funds from which to pay it; see *Leibert v. Grinnell Corp.*, 194 A2d 846, 851 (Del. Ch. 1963) (observing in dicta that provision for mandatory dividends on stock is permissible if lawful funds are available from which to pay them)). Moreover, the rights of the preferred stock are subject to the rights of claimants with priority on the corporation's assets, such as creditors, regardless of the provisions of the preferred stock. In addition, the stated rights of the preferred stock can often be affected by various corporate actions, including a merger in which the preferred stock is exchanged for other securities or its provisions are modified.

25. *Harbinger Capital Master Fund I, Ltd. v. Granite Broadcasting Corporation*, 906 A2d 218, 225 (Del. Ch. 2006).

that the Company has the power to create a provision of the preferred stock under the state corporation statute or the Company's charter and the problem is not corrected, the opinion preparers should take an express exception for that provision or decline to give the opinion at all.²⁶ To illustrate, opinion preparers ordinarily would not be able to give an unqualified opinion if:

- the charter establishes a procedure for declaring dividends that contravenes the corporation statute, such as delegating authority to declare dividends to a third party or fixing the amount of the dividend by reference to an external source when the statute requires that the board of directors or a committee of the board have the authority to declare dividends or prohibits references to external sources in the charter;
- the charter eliminates statutory appraisal rights either by expressly denying those rights or by requiring all holders to vote in favor of a matter if a majority of the class or series so votes (a "drag-along") when under the applicable state corporation statute such a requirement constitutes an impermissible waiver of appraisal rights;²⁷
- the charter provides for a lower percentage vote for approval of certain matters than the vote required by the statute;
- the charter gives holders of a class of stock the right to designate a member of a committee of the board when the statute authorizes only the directors to appoint members of committees of the board; or
- the board pursuant to blank check authority creates a class of stock that is non-voting when a provision in the charter only permits the creation of voting stock.

On the other hand, opinion preparers are not required to take an exception to the duly authorized opinion if the charter mandates redemption of the preferred stock upon the occurrence of a specified event or at the election of the holder even though the applicable corporation statute only permits redemption when the Company has sufficient lawful funds available to effect the redemption.²⁸ That is because corporation statutes usually do not deny corporations the power to create preferred stock with mandatory redemption provisions and, in fact, often expressly authorize creation of stock that is redeemable "at the option of the . . . shareholder . . . or upon the occurrence of a specified event."²⁹ The possibility that a particular provision of the stock, in this case the mandatory redemption

26. The decision whether to give an opinion at all will turn on the opinion preparers' judgment as to whether the provision would lead to invalidation of the preferred stock in its entirety. As discussed in the final paragraph of this report, an exception for a particular provision might not always be sufficient to address the issue.

27. See note 16 *supra* for a decision holding that a provision purporting to abrogate statutory inspection rights is invalid.

28. An exception would not be necessary whether or not the provision is qualified, as it often is, by the phrase "to the extent funds are lawfully available therefor" or the like. If it is not so qualified, however, the opinion preparers, to avoid misunderstanding, may want to consider pointing that limitation out to the opinion recipient.

29. Model Business Corporation Act, § 6.01(c)(2).

provision, might not be given effect in some circumstances is not, as noted above, covered by the duly authorized opinion.³⁰

Depending on state law and the provision in question, a Company's lack of corporate power to create a provision of the preferred stock might give rise to a question regarding the validity of the preferred stock itself.³¹ If it does and the provision is not eliminated or revised to remove the uncertainty regarding the Company's corporate power to create it, the opinion preparers may be unable to give a duly authorized opinion, even with an exception for the problematic provision, or they may be able to do so only by addressing in the opinion the possible effect of the provision on the validity of the preferred stock in its entirety.³²

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30. Unlike preferred stock, in some states common stock cannot be made redeemable. See, e.g., Cal. Corp. Code § 402(c).

31. See *Waggoner v. STARR Surgical Co.*, 1990 WL 28979 at *5, n.7 (Del. Ch. March 15, 1990) (assumes preferred stock was invalid based on holding in *Waggoner v. Laster*, *supra* n.9). In *STARR Surgical Co. v. Waggoner*, 588 A.2d 1130 (Del. 1991), the court held that the invalidity of the preferred stock also could affect the validity of common stock issuable on conversion. Compare *Hildreth*, *supra* note 14 (contrasting *STARR* with the facts in that case and indicating that provisions of preferred stock could be severable.)

The reason for the provision's invalidity might affect the analysis. For example, if the board had the power to create the class of stock in question but not the particular provision, a court might hold the entire preferred stock invalid if the invalidity, in its view, constituted a "fundamental defect" as opposed to a "trivial technicality." See *Liebermann v. Frangiosa*, 844 A.2d at 1004.

32. Comments on this Report are welcome. Comments should be sent to Co-Chairs, TriBar Opinion Committee, c/o New York County Lawyers Association, 14 Vesey St., New York, NY 10007, or alternatively they can be e-mailed to the Reporter at tribar@eapdlaw.com.

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