

Del. Courts Must Grapple With Efforts to Impose Fiduciary Duties on Investors Exercising Contractual Rights

The Chancery Court will continue to face novel theories of controlling stockholder liability based on contract rights, and Delaware's ability to impose clear limits on when an investor's contract rights render it a fiduciary to the company will have significant consequences for corporate finance and strategic investments under Delaware law going forward.

By **Andrew W. Stern, James Heyworth and Benjamin F. Burry** | December 12, 2018 at 09:15 AM

Fiduciary duties are assigned to those trusted to exercise control over the property of another. In the corporate setting, the board of directors has discretion and management authority over the corporation, which is owned by its stockholders. As such, directors owe fiduciary duties to the corporation's stockholders to act in the corporation's best interests.

Since at least the early 20th century, in certain circumstances, Delaware courts have also imposed fiduciary duties on majority stockholders to act for the benefit of the corporation's minority stockholders. Courts reason that where a "controlling stockholder" directs the actions of the board of directors, then the controlling stockholder also must share the board members' fiduciary duty of loyalty to the corporation. In addition to majority stockholders, in even rarer circumstances, minority stockholders also have been deemed "controlling stockholders" when they are found to have "actual control" of the corporation's decision-making such that they are "no differently situated than if they had majority voting control."

Over the last several years, Delaware courts increasingly have been confronted with allegations that a minority stockholder should be deemed a controlling stockholder, with a concomitant fiduciary duty, due to certain contract rights concerning the corporation held by that stockholder. In recent actions before the Delaware Court of Chancery, plaintiffs have alleged that contractual

rights create “blocking” or “veto” power of important corporate transactions, and thus give the defendant the “actual control” sufficient to constitute a controlling stockholder.

The trend in modern corporate finance toward preferred stock, specialized debt, and large private equity holdings in public companies has made this an important issue with significant implications for private investment firms, corporate directors, and public stockholders alike. For transactions ranging from strategic investment in early-stage companies to corporate debt issuance, it is common for corporations to agree to contract provisions giving investors approval rights over mergers, acquisitions, or significant asset sales. These can be very powerful contract rights, to be sure, but imposing fiduciary duties by deeming the holders of such rights to have “actual control” over the corporation has profound implications.

When confronted with these allegations, and in light of the consequences flowing from deeming a person or entity a controller, some Delaware courts have been reluctant to find that contract rights impart controlling stockholder status on an investor. For example, last year in *In re Morgans Hotel Group*, (Del.Ch. Oct. 24, 2017), the Chancery Court held that a preferred stockholder with “contractual blocking rights” was not a controlling stockholder that owed fiduciary duties when it asserted these rights during a period of “financial distress” leading up to the company’s merger. The court found that “Delaware courts have rejected the argument” that the ability to foreclose important transactional alternatives amounted to effective control. In *Thermopylae Capital Partners*, (Del. Ch. Jan. 29, 2016), the Chancery Court similarly rejected an effort to impose fiduciary duties on a minority stockholder by virtue of its “blocking rights” over certain financing transactions. There, the court recognized an important distinction—a stockholder who through majority stock ownership or control of the board “operates the decision-making machinery of the corporation” may be a controlling stockholder, whereas “an individual who owns a contractual right, and who exploits that right—even in a way that forces a reaction by a corporation—is simply exercising his own property rights, not that of others, and is no fiduciary.”

On the other hand, some decisions have cited the exercise of contract rights to block or restrict alternative choices by the corporation as a factor that supports finding that an investor is a controlling stockholder. In *Superior Vision*, for example, the Chancery Court held that a minority stockholder that withheld its consent to dividends, allegedly “to strong-arm individual stockholders or [the company] to further its own agenda,” was only taking advantage of its “specific and fairly negotiated contractual rights” and could not be deemed a controlling stockholder bound by fiduciary obligations on this basis, see *Superior Vision Services v. ReliaStar Life Insurance*, (Del. Ch. Aug. 25, 2006). But the court also acknowledged that “there may be circumstances where the holding of contractual rights, coupled with a significant equity position and other factors, will support the finding that a particular shareholder is, indeed, a ‘controlling shareholder,’ especially if those contractual rights are used to induce or to coerce the board of directors to approve (or refrain from approving) certain actions.”

Meanwhile, Chancery Court complaints that seize on a minority stockholder’s contract rights as a basis for alleging that it is a “controlling stockholder” who breached its fiduciary duties are becoming increasingly common. Most recently, in *Bash Technologies Holdco B v. Georgetown Basho Investors*, (Del. Ch. July 6, 2018), the Chancery Court found a preferred stockholder’s strategic use of its “blocking rights that enabled it to control Basho’s access to capital” exercised “actual control over the company,” thereby rendering to “a fiduciary for purposes of evaluating that transaction.”

Delaware deserves a serious examination of the circumstances under which an investor who holds valuable contract rights may be required to act as a fiduciary. A willingness to impose

fiduciary duties based on powerful or strategic contract rights held by significant debt or private equity investors would be transformative, largely in a negative way. Imposing fiduciary duties means requiring that third parties with such contract rights—which may be pooled investment vehicles with fiduciary duties to their own investors—are bound to act in the best interests of the stockholders of the corporation in which they have invested and/or to which they have loaned money. Moreover, while assigning fiduciary duties to large equity-holders has a natural limiting principle, a corporation that issues debt or executes contracts that confer consent rights over corporate decision-making could potentially create several or many “controlling stockholders,” all acting independently.

The Chancery Court will continue to face novel theories of controlling stockholder liability based on contract rights, and Delaware’s ability to impose clear limits on when an investor’s contract rights render it a fiduciary to the company will have significant consequences for corporate finance and strategic investments under Delaware law going forward. Fairly negotiated contract rights providing for consent or blocking power do not constitute operating “the decision-making machinery of the corporation” in the fashion of a board of directors or majority stockholder. Delaware should be very reluctant to deem someone a controller based, not on rights as a stockholder, but on contractual rights.

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