



Loyal to Whom? Recent Delaware Decisions Clarify Common Stockholders Are Primary Beneficiaries of Directors' Fiduciary Duties

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Delaware case law has long discussed the directors' fiduciary duties of care and loyalty to the corporation and its stockholders in absolute terms.² An often-cited passage from the Delaware Supreme Court describes:

A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.³

Given the unremitting nature of a director's fiduciary duty of loyalty, one of the more interesting questions in corporate law—and one of the most difficult questions directors can face in the boardroom—is how a director can satisfy his duty of loyalty to two or more corporate constituencies if the interests of those constituencies are directly in conflict. This issue arises most commonly when the board is considering a transaction, such as a merger, that will affect preferred and common stockholders differently or will require the board to apportion the aggregate merger consideration between common and preferred

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² *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); see also *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (there is no dilution of a director's duties where that director holds dual or multiple directorships).

³ *Guth*, 5 A.2d at 510.

stock. Recent decisions from the Delaware Court of Chancery and the Delaware Supreme Court provide much-needed guidance in this area. These cases clarify that where the interests of preferred and common stockholders conflict, directors may prefer the interests of the corporation's common stockholders, as long as the contractually defined rights of the preferred stockholders are honored.

The first Court of Chancery decision is an opinion by Chancellor Chandler in *In re Trados Inc. Shareholder Litigation*,⁴ which denied a motion to dismiss claims for breach of fiduciary duty brought by a former common stockholder of Trados challenging the sale of the company in which the preferred stockholders and management—who together controlled a majority of the company's board—received all of the merger consideration and the common stockholders received nothing. The second Court of Chancery decision is an opinion by Vice Chancellor Strine in *LC Capital Master Fund, Ltd. v. James*,⁵ which denied a motion for preliminary injunction brought by a preferred stockholder of QuadraMed to enjoin a merger due to an alleged breach of fiduciary duty by the company's board for failing to allocate additional merger consideration to the company's preferred stockholders.

In both *Trados* and *LC Capital*, the Court of Chancery concluded that the board did not owe fiduciary duties to the preferred stockholders, other than those owed to all stockholders generally, in connection with the challenged transaction. Having found that no unique fiduciary duty was owed to the preferred stockholders as a distinct class, the Court of Chancery held that because the rights of the preferred stockholders are contractually defined, the directors' fiduciary duties required them to act to advance the interests of the common stockholders where the interests of the preferred and common stockholders were in conflict.

The distinction between contractual and fiduciary duties was also the subject of the Delaware Supreme Court decision in *Nemec v. Shrader*,⁶ in which the Delaware Supreme Court affirmed the dismissal of fiduciary duty claims against the directors of Booz Allen for approving the redemption of shares of common stock from two former officers in advance of a merger transaction, thereby depriving the former officer stockholders of the financial benefits of the merger. In *Nemec*, the Supreme Court stated that "it is a well-settled principle that where a dispute arises from obligations that are expressly addressed by contract...any fiduciary claims arising out of the facts that underlie the contractual obligations would be foreclosed as superfluous."⁷

Additionally, the *Trados*, *LC Capital* and *Nemec* decisions addressed the application of the business judgment rule to the decision to approve a transaction, discussing the question of whether directors could be deemed interested in the decision based upon their relative ownership of common or preferred stock of the company. In this regard, these decisions suggest that common stock ownership, standing alone, should not give rise to any disqualifying interest, but that material preferred holdings (or material ties to the preferred investor) may be a disqualifying conflict sufficient to rebut the presumption of the business judgment rule.

A. The Decisions

1. *In re Trados Incorporated Shareholders Litigation*⁸

During 2004, Trados's lack of liquidity and disappointing business results caused its board of directors to begin considering a potential sale of the company.⁹ At this time, the Trados board was made up of seven members—four of whom were appointed as representatives of venture capital firms that had invested in the company through the purchase of preferred stock.¹⁰ The preferred stockholders had a contractual right to a liquidation preference of \$57.9 million, and the liquidation preference would be triggered by

⁴ 2009 WL 2225958 (Del. Ch. July 24, 2009).

⁵ 990 A.2d 435 (Del. Ch. 2010).

⁶ __ A.2d __, 2010 WL 1320918 (Del. Apr. 6, 2010).

⁷ *Id.* at *6.

⁸ The *Trados* opinion decided defendants' motion to dismiss the complaint. Therefore, the facts in the opinion are based only on the pleadings and are viewed in the light most favorable to the plaintiff.

⁹ *Trados*, 2009 WL 2225958, at *2.

¹⁰ *Id.* at *1.

a sale of the company.¹¹ However, the preferred stockholders did not have any contractual right to force the company to enter into a transaction that would trigger their liquidation preference.¹² After the initial attempts to sell Trados were unsuccessful, the board installed new management.¹³ Eventually, under the new and more aggressive management, the financial condition of Trados began to improve.¹⁴

Despite its improved financial condition, the company continued to search for potential acquirors.¹⁵ Around the same time, in order to incentivize management to remain with the company and to attempt to obtain the best price in a sale, the board approved a management incentive plan under which certain members of management would receive a graduated percentage of the price obtained for Trados in an acquisition.¹⁶ Two of the directors were employees and would receive payments under the management incentive plan in the event of a sale.¹⁷

In early 2005, Trados entered into a letter of intent to sell the company for \$60 million.¹⁸ Pursuant to the management incentive plan, certain Trados employees would be entitled to receive \$7.8 million of the purchase price.¹⁹ Because the merger also would trigger the liquidation preference of the preferred stockholders, the remaining \$52.2 million would be paid to the preferred stockholders in partial satisfaction of their liquidation preference.²⁰ There would be no merger consideration remaining to be distributed to the common stockholders.²¹ The Trados board unanimously approved the merger, the merger agreement was signed and shortly thereafter the merger closed.²²

The plaintiff, a former common stockholder of Trados, filed suit alleging that the Trados board breached its fiduciary duties by approving the merger to satisfy the desire of the preferred stockholders to monetize their investment without properly considering the interests of the common stockholders.²³ The defendants responded by filing a motion to dismiss for failure to state a claim.²⁴

In addressing the motion to dismiss, the Court found that Trados's improved performance in the months leading up to the merger made it reasonable to infer that the common stockholders may have been able to receive some consideration from their shares at some point in the future if the merger had not taken place.²⁵ In fact, the Court noted that it would not "stretch reason to say that this [was] the worst possible outcome for the common stockholders."²⁶ The Court held that where the interests of the common and preferred stockholders diverge, the board could breach its fiduciary duties by improperly favoring the interests of the preferred stockholders over the interests of the common stockholders.²⁷ With regard to the Trados board's decision of whether or not to approve a merger that would provide all of the consideration to management and the preferred stockholders and leave nothing for the common stockholders, the Court found that it was reasonable to infer that the interests of the common and preferred stockholders did diverge.²⁸

¹¹ *Id.* at *4.

¹² *Id.* at *7 n.38.

¹³ *Id.* at *2.

¹⁴ *Id.* at *3.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.* at *4.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.* at *1.

²⁴ *Id.* at *4.

²⁵ *Id.* at *7.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

Moreover, the Court found that the plaintiff pled facts sufficient to suggest that a majority of the Trados directors were interested in the merger transaction.²⁹ Four of the seven Trados directors were designated by the preferred stockholders and were also dependent on those preferred stockholders for their livelihood.³⁰ The Court, on a motion to dismiss, held that these allegations were sufficient to rebut the presumption of the business judgment rule with regard to the board's decision to approve the merger.³¹ Thus, the Court denied the defendants' motion to dismiss.³²

The Court expressly noted, however, that it is not necessarily a breach of fiduciary duty to approve a transaction that would not provide any consideration to the common stockholders due to the liquidation preferences of the preferred stockholders.³³ Moreover, the Court in *Trados* expressly noted that, on a motion to dismiss, the Court could not consider or weigh alternative, but perhaps equally reasonable, inferences that might support the directors' decision, such as the inference that pursuing "the transaction with SDL was in the best interests of the Company because it secured the best value reasonably available for the Company's stakeholders and did not harm the common shareholders because, in fact there was no reasonable chance that they would ever obtain any value from their stock even absent the transaction."³⁴ Thus, the *Trados* decision should not be read as establishing that directors may not validly approve a transaction that favors the interests of preferred stockholders under any circumstances.

2. *LC Capital Master Fund, Ltd. v. James*

Since 2008, the board of QuadraMed Corporation had been considering a sale of the company.³⁵ To facilitate this process, the board formed a special committee to evaluate the various bids received by the company.³⁶ The committee was comprised of independent directors who, with one exception,³⁷ held only a nominal amount of QuadraMed's common stock and in-the-money options.³⁸ None of the committee members owned any QuadraMed preferred stock.³⁹

QuadraMed's certificate of incorporation, which set forth the rights and preferences of the preferred stockholders, provided the preferred stockholders with a liquidation preference of \$25 per share plus accrued dividends, but did not give the preferred stockholders the right to force a liquidation and expressly provided that the liquidation preference was not triggered in the event of a merger.⁴⁰ The certificate permitted the preferred stockholders at any time to convert their stock into common stock at a ratio determined by the certificate, and required the company to give the preferred stockholders advance notice of any merger. Functionally, the certificate gave the preferred stockholders a choice, in the event of a merger that would

²⁹ *Trados*, 2009 WL 2225958, at *8.

³⁰ *Id.*

³¹ *Id.*

³² *Id.* at *9.

³³ *Id.* at *7 n.36. The Court cited *Orban v. Field*, 1997 WL 153831 (Del. Ch. Apr. 1, 1997), in which the Court of Chancery, in deciding a motion for summary judgment, found that the members of the board (a majority of whom were preferred stock designees) did not breach their fiduciary duties by approving a merger transaction where, due to the liquidation preferences of the preferred stockholders, the common stockholders did not receive any merger consideration. The Court in *Trados* specifically distinguished *Orban* based on the procedural posture of the case—the *Trados* decision was made on a motion to dismiss, while *Orban* was addressing a motion for summary judgment. *Trados*, 2009 WL 2225859, at *9. Similarly, a recent decision of the Superior Court of California, *Alexandros v. Kor Electronics, C.A. No. 06-CC-0788* (Cal. Super. Ct. Feb. 25, 2010), rejected a challenge by a common stockholder that the board of Kor Electronics breached its fiduciary duty to the common stockholders by approving a recapitalization that benefitted preferred stockholders while eliminating common equity. Highlighting the importance of disinterested decision making, the *Kor* Court relied upon the fact that the recapitalization was approved by a special committee comprised of directors who did "not hav[e] the conflict of preferred stock holdings since the preferred might benefit from the decision made." *Id.* at 4.

³⁴ *Trados*, 2009 WL 2225859, at *7 n.36; see also *Blackmore Partners, L.P. v. Link Energy LLC*, 864 A.2d 80, 86 (Del. Ch. 2004) (denying motion to dismiss a claim where the company's creditors received all of the consideration in a transaction and the equity unitholders received nothing and noting that the record, at a later stage in the proceedings, may show that there was no better alternative for the unitholders).

³⁵ *LC Capital*, 990 A.2d at 441.

³⁶ *Id.* at 442.

³⁷ One member owned 650,000 shares of the company's common stock. *Id.*

³⁸ *Id.* In-the-money options are rights to purchase stock at a price lower than the current fair market value of the stock.

³⁹ *Id.* at 445.

⁴⁰ *Id.* at 440.

take out the common stock, between the consideration specified in the merger agreement or (through exercise of the conversion right) the consideration payable to the common stockholders.⁴¹

Early in the sale process, the preferred stockholders demanded a transaction that would provide them a high price, even the \$25 liquidation preference.⁴² In light of the demands of the preferred stockholders, the special committee carefully considered the duties that it owed to both the preferred and common stockholders and received the advice of counsel regarding those duties.⁴³ Counsel advised the special committee that it could adopt a merger agreement that cashed out the preferred stockholders as long as the agreement respected the contractual rights of the preferred stockholders, and that it was not required to give additional consideration, above what was contractually required, to the preferred stockholders.⁴⁴ In fact, the special committee's counsel cautioned that the committee should be hesitant to provide additional consideration to the preferred stockholders unless it had a special reason to do so.⁴⁵

Ultimately, the special committee recommended and the board approved a merger agreement with Francisco Partners II, L.P., under which the stockholders would receive \$8.50 per share of common stock and \$13.7097 per share of preferred stock.⁴⁶ The consideration payable to the preferred stockholders was equal to the consideration to which the preferred stockholders would have been entitled had they converted their shares into shares of common stock.⁴⁷ Prior to giving its approval, the special committee obtained a fairness opinion from Piper Jaffray that \$8.50 per share of common stock was fair from a financial point of view to the common stockholders.⁴⁸ The committee did not obtain a separate opinion to evaluate the fairness, from a financial point of view, of the consideration payable to the preferred stockholders.⁴⁹

The plaintiff, a preferred stockholder who purported to have the support of 95 percent of the company's preferred stockholders, sought to enjoin the merger, alleging that the board breached its fiduciary duties to the preferred stockholders by failing to allocate more of the merger consideration to them.⁵⁰ The plaintiff argued that, as a result of the contractual rights of the preferred stockholders set forth in the certificate, including a strong liquidation preference and non-mandatory rights to dividends, the board had a fiduciary duty to allocate more than the as-if-converted consideration to the preferred stockholders.⁵¹ The plaintiff suggested that to comply with its alleged fiduciary duties to the preferred stockholders, the board was required to appoint a negotiating agent to exert leverage on behalf of the preferred stockholders during the board's discussion of the allocation of the merger consideration.⁵² Moreover, the plaintiff argued that the board's duties to the preferred stockholders were heightened because the members of the special committee owned common stock but did not own any preferred stock.⁵³

The Court began its analysis by noting that where a contract provides the preferred stockholders with specified rights in the event of a transaction, a board generally is not required to do more than what is required under the contract.⁵⁴ In the absence of applicable contractual provisions, by contrast, the board may have a "gap-filling duty" to do its best to fairly reconcile the competing interests of the common and preferred stockholders.⁵⁵ Because the QuadraMed certificate of incorporation set forth the preferred

⁴¹ *Id.*

⁴² *Id.* at 441.

⁴³ *Id.* at 443.

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* at 439.

⁴⁷ *Id.*

⁴⁸ *Id.* at 444.

⁴⁹ *Id.*

⁵⁰ *Id.* at 438. The plaintiff did not allege that the board breached its *Revlon* duties to all of the stockholders by failing to obtain the highest price reasonably attainable in the merger. See *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985) (articulating a board's duty to maximize stockholder value in a change of control transaction).

⁵¹ *LC Capital*, 990 A.2d at 438.

⁵² *Id.* at 445.

⁵³ *Id.*

⁵⁴ *LC Capital*, 990 A.2d at 438.

⁵⁵ *Id.*; see also *FLS Holdings, Inc. S'holders Litig.*, 1993 WL 104562, at *4-5 (Del. Ch. Apr. 2, 1993).

stockholders' "bottom-line" rights in the event of a merger, the Court held that the board was only required to do what was mandated by the certificate.⁵⁶

The Court concluded that the board fulfilled its obligations to the preferred stockholders pursuant to the certificate—the right to convert their shares to common stock and receive the same consideration received by the common stockholders on an as-converted basis.⁵⁷ In rejecting the preferred stockholders' argument that they should have received greater consideration, the Court noted that if the board were to give the preferred stockholders additional consideration, it would, "in essence, give [the preferred stockholders] leverage that they did not fairly extract in the contractual bargain, a hold-up value of some kind that acts as a judicially imposed substitute for the voting rights and other contractual protections that they could have, but did not obtain in the context of a merger."⁵⁸ The Court held that once the board fulfilled the contractual rights of the preferred stockholders, it was entitled to favor the interests of the common stockholders,⁵⁹ and citing to *Trados*, the Court held that where the interests of the preferred and common stockholders diverge, it is the duty of the board to prefer the interests of the common stockholders.⁶⁰

In response to the plaintiff's suggestion that individual committee members' ownership of common stock rendered them interested in the transaction, the Court expressed concern that denying otherwise independent directors the protection of the business judgment rule when considering a merger based solely on their ownership of common stock would be inconsistent with the long-held view that it is useful for directors to own common stock in the company because stock ownership aligns their interest with the common stockholders and "give[s] them personal incentive to fulfill their duties effectively."⁶¹ Relying upon Delaware precedent establishing that "it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred,"⁶² the Court held that the otherwise independent QuadraMed directors were not interested in the merger transaction solely due to their ownership of the company's common stock.⁶³

3. *Nemec v. Shrader*

During mid-2007, the board of Booz Allen, which collectively owned 11 percent of Booz Allen's outstanding common stock, began considering a possible transaction to sell its government services business unit.⁶⁴ By the end of March 2008, Booz Allen and The Carlyle Group ("Carlyle") had negotiated a merger whereby Carlyle would purchase Booz Allen's government business unit for \$2.54 billion—a price that would generate over \$700 per share to the Booz Allen stockholders.⁶⁵

Pursuant to Booz Allen's stock plan, Booz Allen partially compensated its officers with annual grants of stock rights that were convertible into common stock.⁶⁶ Upon retirement, each retired officer of the company received a "put" right that is exercisable for two years from the date of his retirement to sell his

⁵⁶ 990 A.2d at 438-39.

⁵⁷ *Id.*

⁵⁸ *Id.* at 451.

⁵⁹ *Id.* at 438.

⁶⁰ *Id.* at 452. The Court pointed out that it is not suggesting that the board owes no duties to the preferred stockholders, but that it only owes duties to the preferred stockholders to the extent that the preferred stockholders' interests are co-extensive with the interests of the common stockholders. *Id.* at 449. For example, in the merger context, the board owes a duty to all stockholders under *Revlon* to make a reasonable effort to obtain the highest price reasonably available.

⁶¹ *Id.* at 452.

⁶² *Id.*

⁶³ *Id.* at 452-53. The plaintiff did not allege that the committee members' holdings in the company's common stock constituted a material portion of their personal wealth. *Id.* at 442; see *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611, 617 (Del. Ch. 1999) (in order to show that a director's independence was compromised, plaintiff must show that his holdings in the company's stock and "the predominance of such holdings" was of a "sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform [his] fiduciary duties" without being influenced by the performance of his holdings in the company).

⁶⁴ *Id.* at *2.

⁶⁵ *Id.* at *2. Additionally, Booz Allen entered into a spin-off agreement to transfer its remaining business unit—the commercial business unit—to the newly formed entity, Booz & Company, Inc. *Id.*

⁶⁶ *Nemec*, 2010 WL 1320918, at *1.

stock back to the company at book value.⁶⁷ After the expiration of the two-year put period, the company had the right, at any time, to redeem part or all of the retired officer's stock at book value.⁶⁸

Shortly after Booz Allen and Carlyle agreed to a purchase price but prior to the closing of the merger, Booz Allen exercised its right to redeem the stock retained by two retired officers, whose two-year put rights had expired, at the company's pre-transaction book value of \$162.46.⁶⁹ The redemption of the former officers' stock at the pre-transaction book value added approximately \$60 million to the merger proceeds received by the remaining Booz Allen stockholders upon closing of the Carlyle transaction.⁷⁰

The former officers whose stock was redeemed filed suit alleging, *inter alia*, that the Booz Allen directors breached their fiduciary duty of loyalty by causing the company to redeem their stock prior to the closing of the transaction with Carlyle, thus favoring the directors' own personal economic interests as owners of the company's common stock.⁷¹ The former officers further alleged that Booz Allen breached its duty of good faith and fair dealing implied in the stock plan by redeeming the stock at a time when the transaction with Carlyle was almost certain to occur.⁷² The defendants moved to dismiss the complaint for failure to state a claim.⁷³ The Court of Chancery granted the defendants' motion, and the plaintiffs appealed that decision to the Delaware Supreme Court.⁷⁴

The Delaware Supreme Court, in a majority decision, affirmed the Court of Chancery's decision, holding that "it is a well-settled principle" that disputes arising from rights set forth by contract will be treated as breach of contract, as opposed to breach of fiduciary duty, claims.⁷⁵ The Supreme Court further held that "any fiduciary claims arising out of the same facts that underlie the contract obligations would be foreclosed as superfluous."⁷⁶ The plaintiffs attempted to distinguish their fiduciary claim from a contractual claim by arguing that their fiduciary duty claim is based on the additional fact that the Booz Allen directors, who made the decision to redeem the stock, stood to gain personally from that decision through their ownership of the company's common stock.⁷⁷ The Supreme Court rejected that argument, noting that, regardless of when the board decided to redeem the plaintiffs' stock, the dispute still arose from the company's contractual right under the stock plan to redeem retired officers' shares.⁷⁸ As such, the plaintiffs' fiduciary duty claims were foreclosed and the Supreme Court affirmed the Court of Chancery's dismissal of that claim.⁷⁹

In also affirming the Court of Chancery's dismissal of the plaintiffs' breach of the implied covenant of good faith and fair dealing claim,⁸⁰ the Supreme Court found that the Booz Allen "directors did nothing unfair and breached no fiduciary duty by causing the Company to exercise its absolute contractual right to redeem the retired stockholders' shares at a time that was most advantageous to the Company's [remaining] stockholders."⁸¹ Additionally, the Supreme Court affirmed the Court of Chancery's conclusion that the fact that some directors owned common stock and thus received a *pro rata* share of the \$60 million due to the redemption of the plaintiffs' shares did not cause those directors to be personally interested in the decision "because those director stockholders received the same *pro rata* benefit as all other stockholders similarly situated."⁸²

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* at *3.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.* at *6. The Court's opinion was joined by three of the five justices of the Delaware Supreme Court, with two justices dissenting.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.* at *4.

⁸¹ *Id.* at *4.

⁸² *Id.*

Two justices dissented from the majority's opinion affirming the Court of Chancery's dismissal of the implied covenant claim, finding that the complaint adequately alleged that the redemption prejudiced plaintiffs while serving no legitimate corporate interest of Booz Allen.⁸³ The dissent stated that a party can breach the implied covenant if that party exercises its contractual power "arbitrarily and unreasonably." Thus, the dissent would have held that plaintiffs' claim was legally cognizable.⁸⁴

In reaching this conclusion, the dissent reasoned that eliminating the interests of the retired stockholders for the lowest contractually permissible cost advanced no valid purpose of the company, as distinct from the interests of the still-working stockholders, and suggested that the board may have breached the stock plan's implied covenant of good faith and fair dealing to the retired stockholders by acting to favor the interests of the working stockholders over those of the retired stockholders.⁸⁵ The view articulated by the dissent therefore suggests that two of the five justices of the Delaware Supreme Court may view the duty of good faith and fair dealing as providing a framework for evaluating the duties owed to preferred holders and within that framework, may not readily agree with the suggestion in *Trados* and *LC Capital* that directors may freely act to prefer the interests of common stockholders to the detriment of preferred stockholders, after honoring the preferred stockholders' contract rights.

B. *Trados* and *LC Capital* Reaffirm that the Primary Beneficiary of Directors' Fiduciary Duties Are the Common Stockholders

Some commenters have suggested that *Trados* and *LC Capital* reflect a shift in Delaware law or a lessening of fiduciary protections afforded to preferred stockholders.⁸⁶ When viewed in context, however, these cases are simply an extension and reaffirmation of the principle that preferred stockholders' rights are primarily contractual and that no unique fiduciary protections are afforded to preferred stockholders where their rights have been addressed by contract.

Delaware courts consistently have held that the special protections granted to a company's preferred stockholders through a certificate of incorporation⁸⁷ are contractual in nature and that claims relating to such protections will be decided in accordance with contractual, not equitable, principles.⁸⁸

Thus, preferred stockholders cannot bring claims for breach of fiduciary duty against the corporation or its board where the claim relates to a contractual preference.⁸⁹ This principle is consistent with the Delaware Supreme Court's majority opinion in *Nemec*, which characterized the principle that a dispute arising from contractual rights will be evaluated based on contractual rather than equitable principles as "well settled" under Delaware law and affirmed the dismissal of fiduciary duty claims where the rights of

⁸³ *Id.* at *7.

⁸⁴ *Id.* at *8.

⁸⁵ *Id.*

⁸⁶ See, e.g., Michael D. DiSanto, et al., *Delaware Decision Raises Concerns For Private Company Directors*, at <http://mondaq.com/unitedstates/article.asp?articleid=87096&print=1> (suggesting that *Trados* was a shift in the law by raising the possibility that directors could breach their fiduciary duties by approving a transaction that favors the preferred stockholders).

⁸⁷ Preferred stock terms may be created by the certificate of incorporation or by a certificate of designations which becomes a part of the company's certificate of incorporation pursuant to 8 *Del. C.* § 151. For clarity, the term certificate of incorporation is used herein.

⁸⁸ See, e.g., *Winston v. Mandor*, 710 A.2d 835, 845 (Del. Ch. 1997) (when "corporate actions complained of are expressly contemplated by a certificate, the duties and obligations of the corporation and its preferred stockholders are governed exclusively by their contract"); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 (Del. Ch. 1997) ("The special protections offered to the preferred are contractual in nature."); *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, 1995 WL 662685, at *5 (Del. Ch. Nov. 2, 1995) ("The relationship between a corporation and its preferred stockholders is 'primarily ... contractual in nature,' involving 'rights and obligations created contractually by the certificate of designation.'"); *HB Korenvaes Invs., L.P. v. Marriott Corp.*, 1993 WL 205040, at *3 (Del. Ch. June 9, 1993) ("with respect to the proposed special dividend, the rights of [the preferred stockholders] are contractual in nature and not equitable"); *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 937 (Del. 1979) ("For most purposes, the rights of the preferred shareholders as against the common shareholders are fixed by the contractual terms agreed upon when the class of preferred stock is created."); *Ellingwood v. Wolf's Head Oil Ref. Co.*, 38 A.2d 743, 747 (Del. 1944) ("rights of stockholders are contracts rights and [] it is necessary to look to the certificate of incorporation to ascertain what those rights are").

⁸⁹ See, e.g., *Moore*, 1995 WL 662685, at *6; see also *Winston*, 710 A.2d at 845 (noting that because the company's actions with regard to the UPI transactions were expressly provided for in the certificate, claims attacking those transactions "must come by challenge to defendants[] compliance with the provisions of the Certificate").

the stockholders were defined by contract.⁹⁰ Therefore, where the rights of the preferred stockholders with regard to a particular transaction are set forth contractually, the board is entitled to favor the interests of the common stockholders related to that transaction.⁹¹

However, while the rights of preferred stockholders are typically contractual in nature, they are not exclusively so.⁹² As recognized in *LC Capital*, where the rights of preferred stockholders are co-extensive with the rights of the common stockholders, the board may owe a fiduciary duty to preferred and common stockholders alike, as in the case of a sale of control transaction implicating the board's duties under *Revlon* to maximize value.⁹³ Delaware cases have held that in circumstances where the certificate of incorporation does not expressly define the rights of the preferred stock, a preferred stockholder⁹⁴ will have the same rights as the common stockholders and thus the board will owe the preferred stockholders fiduciary duties consistent with those owed to the common stockholders.⁹⁵

Thus, whether a board owes fiduciary duties to preferred stockholders will depend on a fact-specific inquiry as to the terms of the certificate of incorporation and the transaction at issue, and a determination as to whether the certificate defines the rights of the preferred stockholders in the event of the type of transaction being considered. Under *Trados* and *LC Capital*, if the preferred stockholders' rights in the event of a transaction are defined in the certificate of incorporation, then the company is required only to fulfill those contractual obligations, and once the contractual obligations are satisfied, directors' fiduciary duties require that the directors act to further the interests of the common stockholders. Directors will face the more difficult task of attempting to balance fiduciary obligations owed to both preferred and common stockholders (whose interests may be directly in conflict with one another) only where the certificate of incorporation fails to provide any special protections to preferred stockholders with respect to the transaction or decision at issue.⁹⁶

C. Application of the Business Judgment Rule and Ownership of Common or Preferred Stock

In *Trados*, the Court of Chancery, ruling on a motion to dismiss, held that the directors designated by (and beholden to) preferred stockholders would be considered to lack independence with respect to the decision to approve a transaction that benefitted preferred stockholders at the expense of the common

⁹⁰ 2010 WL 1320918, at *6. The dissenting opinion in *Nemec*, however, would have permitted a contractual claim for breach of the duty of good faith to proceed, leaving residual uncertainty as to the right of directors to freely favor the interests of the common stockholders. *Id.* at *10.

⁹¹ The Delaware courts have also held that boards are entitled to favor the interests of their common stockholders over the interests of other contractual stakeholders, including their creditors and their debt holders. See, e.g., *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 94 (Del. 2007) ("the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's" creditors because directors do not owe creditors duties beyond fulfilling the relevant contract provisions); *Blackmore Partners, L.P. v. Link Energy LLC*, 2005 WL 2709639, at *6 (Del. Ch. Oct. 14, 2005) (absent "special circumstances," such as insolvency, directors do not owe creditors duties beyond the applicable contractual provisions); *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) (the relationship between a company and its debt holders is contractual in nature and "[i]t is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders; that they may sometimes do so 'at the expense' of others...does not for that reason constitute a breach of duty").

⁹² *Moore*, 1995 WL 662685, at *5 ("in limited circumstances fiduciary duties may be owed to preferred stockholders as well").

⁹³ See, e.g., *Revlon*, 506 A.2d at 182.

⁹⁴ *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593 (Del. Ch. Apr. 11, 1986) ("absent negotiated provision conferring rights on preference stock, it does not follow that no right exists").

⁹⁵ *Winston*, 710 A.2d at 845 ("the corporation's duties and obligations to preferred stockholders include fiduciary responsibilities where the acts extend beyond the bounds of the contractual relationship created by the certificate"); *Moore*, 1995 WL 622685, at *5 (directors owe fiduciary duties to the preferred stockholders consistent with the duties owed to other shareholders and to the corporation); *FLS Holdings*, 1993 WL 104562, at *4 (in the absence of a contract providing for the preferred stockholders' rights in the event of a merger, the board owes fiduciary duties to both the preferred and common stockholders in allocating the merger consideration); *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1062 (Del. Ch. 1987) (directors are fiduciaries for the preferred stockholders, "whose interests they have a duty to safeguard, consistent with the fiduciary duties owed by those directors to [the company's] other shareholders and to [the company] itself"); *Jedwab*, 509 A.2d at 593 ("At common law and in the absence of an agreement to the contrary all shares of stock are equal").

⁹⁶ Robust procedural protections, such as appointment of an independent committee charged with negotiating on behalf of the preferred stockholders, may therefore be necessary where the rights of the preferred stockholders are not defined in the certificate of incorporation.

stockholders.⁹⁷ In *LC Capital*, by contrast, the Court of Chancery Court rejected the argument that directors who owned only common stock, and no preferred, were interested with respect to a decision that benefitted the common stockholders at the expense of the preferred stockholders.⁹⁸

These apparently inconsistent results are explained by—and are the necessary consequence of—the fact that, in the circumstances presented in these cases, the directors owed fiduciary duties to the common stockholders but owed only contractual duties to the preferred. Thus, the directors' common stock ownership served to align the personal interests of the directors with those to whom their fiduciary duties were owed, but material ties to preferred investors had the potential to cause the directors' personal interests to diverge from the interests of the common stockholders to whom the directors owed their fiduciary duties.

D. Lessons to Be Learned from *Trados*, *LC Capital*, and *Nemec*

Situations in which directors owe—or feel they owe—fiduciary obligations to two constituencies whose interests conflict are among the most difficult situations directors and those who counsel them will face. The decisions in *Trados*, *LC Capital*, and *Nemec* give directors additional comfort that when the interests of corporate constituencies diverge, the directors' focus can—and should—remain on the interests of the corporation's common stockholders, consistent with any contractual protections granted to other corporate constituencies such as preferred stockholders or debt holders.

From the perspective of preferred investors and those who structure preferred stock investments, *Trados*, *LC Capital*, and *Nemec* reflect that Delaware courts will interpret preferred stockholders' rights as contractual rather than fiduciary in nature in circumstances where the certificate of incorporation grants special rights to the preferred stockholders with respect to the transaction at issue. As a result, preferred protections must always be drafted with the understanding that such rights will replace, rather than supplement, fiduciary protections.

Additionally, preferred investors who have the right to appoint or designate directors should be alert to the various conflicts of interest these directorships can create. In structuring a preferred investment, consideration should be given to the overall composition of the board in order to balance the investors' desire for a significant voice on the board against the risks associated with having a significant portion or majority of the board potentially disqualified from considering transactions that will benefit the preferred investor. In some circumstances, it may be advisable to consider designating individuals who are not employed by or beholden to the preferred investor in order to minimize the risk that the director designees will be deemed to lack independence when considering transactions that may differently affect preferred and common stockholders.

Finally, when a potential transaction or decision involves a conflict between the interests of common and preferred stockholders, the board should ensure that any directorial conflicts of interest are appropriately disclosed and addressed. This may include the formation of an independent committee of directors or the abstention by potentially conflicted directors from discussions, negotiations, and voting on the transactions. Addressing such potential conflicts of interest in advance will significantly improve the likelihood that any decision—even one that benefits preferred stockholders at the expense of common stockholders—will be protected by the business judgment rule.

⁹⁷ *Trados*, 2009 WL 2225958, at *8.

⁹⁸ *LC Capital*, 990 A.2d at 452; see also *Nemec*, 2010 WL 1320918, at *4 (directors' ownership in the company did not render them interested with respect to a decision that benefitted current employee stockholders at the expense of retired employee stockholders).