

Court of Chancery of Delaware: Creditor Deemed a Controller by Dint of Its Voting Power and Consequently Owed Stockholders a Duty of Loyalty (Securities Law Alert)

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On February 28, 2022, the Court of Chancery of Delaware denied dismissal of a breach of fiduciary duty claim in a putative class action brought by a target company's former stockholders against the target's largest creditor, which had threatened to block the target's pending SPAC merger unless the target's board agreed to a series of amendments to debt and warrant agreements. [Blue v. Fireman, 2022 WL 593899 \(Del. Ch. 2022\) \(Zurn, V.C.\)](#). The court concluded that plaintiffs sufficiently pled that the creditor was the target's controller by virtue of its voting power and, therefore, owed the target's stockholders a duty of loyalty. The court further determined that plaintiffs pled that the creditor breached that duty by refusing to vote its proxy in favor of the merger unless it received the amendments it sought.

Background

In 2020, around the time the target was negotiating the key terms of its pending merger with a SPAC, its largest creditor demanded favorable amendments to debt and warrant agreements. The creditor controlled 83% of the target's voting power through an irrevocable proxy. After the target board unanimously approved the merger documents, the creditor declared that it would not vote its proxy in favor of the merger unless its demands were met. The target board went on to approve the amendments and announced the merger, which was valued at approximately \$120 million. Plaintiffs, former target stockholders, commenced this action alleging breach of fiduciary duty, among other claims, against the creditor and its affiliates as controllers, and certain directors the creditor had appointed to the target's board. Plaintiffs alleged that as a result of the amendments, \$40 million in merger consideration was diverted from the target's stockholders to the creditor. Defendants moved to dismiss.

Plaintiffs' Breach of Fiduciary Duty Claim Was Direct

As a threshold matter, the court determined that plaintiffs' claims were direct, not derivative, such that plaintiffs' standing was not extinguished by the merger. Referencing longstanding Delaware precedent, the court specifically determined that plaintiffs' breach of fiduciary duty claim was direct because it alleged that the merger was unfair due to the improper, material diversion of merger proceeds from the

stockholders to the creditor.^[1]

The court explained that plaintiffs alleged that the board’s decision to approve the amendments diverted merger proceeds to a controller—the creditor—in a way that “tainted the merger’s fairness and materially reduced the merger consideration for [the target’s] other stockholders.” The court also found that the timing of the amendments with respect to the merger negotiations indicated the diverted consideration would have otherwise gone to the stockholders, which called the merger’s fairness into question. As to whether the diversion was improper, the court noted that the creditor “was able to wield its influence to extract a benefit for itself at the expense of [the target’s] stockholders.” The court pointed out that even though the creditor did not actually use its proxy to block the merger, it “does not mean its threats to do so are not improper.”

Plaintiffs Pled the Creditor Is a Controller

The court determined that plaintiffs pled that the creditor, standing alone, was a controller that owed fiduciary duties to the target stockholders. The court explained that “[o]ne method of pleading control sufficient to impose fiduciary duties is to allege that a defendant has the ability to exercise a majority of the corporation’s voting power.” Quoting *Voigt v. Metcalf*, 2020 WL 614999 (Del. Ch. Feb. 10, 2020). The court continued that “Delaware law is well-settled that a stockholder who can exercise more than 50% of a company’s voting power is a controller.” The court emphasized that in this case the creditor held both debt and its irrevocable proxy; that it was inconsequential that the creditor secured its voting power via the creditor-debtor relationship; and that the creditor had control because it could vote most of the target’s stock, not because it held most of the target’s debt.

The court then determined that defendants did not meaningfully dispute that plaintiffs pled that the target’s fiduciaries breached their duties. Specifically, the court determined that plaintiffs pled breaches in the director defendants’ decision to approve the amendments and in the creditor’s role in causing the amendments to be approved. The court further stated that the creditor’s procurement of the amendments triggered entire fairness review. The court stated that “[h]ere, as in *Straight Path*, [the creditor] competed with [the target’s] common stockholders by extracting a different benefit (the Amendments) out of the Merger consideration.”^[2]

Notably, the court stated that whether entire fairness should apply to the merger or only the amendments was not entirely clear from the existing case law and requested supplemental briefing on the scope of the creditor’s burden under entire fairness.

^[1] “*Golaine* [*v. Edwards*, 1999 WL 1271882 (Del. Ch. 1999)], as applied in *Houseman*, *Straight Path*, and *Komen*, instructs that to be direct, the side transaction must divert merger consideration from stockholders, rather than from the acquirer; the diversion must be ‘improper,’ that is, the product of misconduct by the defendants; and the diversion must materially affect the merger’s process or price, calling the merger’s fairness or validity into question.”

^[2] *In re Straight Path Comme’ns Consol. S’holder Litig.*, 2018 WL 3120804 (Del. Ch. June 25, 2018).

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