IN THE SUPREME COURT OF THE STATE OF DELAWARE

SIERRA GP LLC, SIERRA RESOURCES, INC., THE BANK OF NEW YORK MELLON TRUST COMPANY, N.A., SARAH W. BRYANT, ROBERT P. GRAY, RICHARD T. HANSON. ELIZABETH F. PRINCE, AND JOHN W. REYNOLDS	:	No. 31, 2016
	:	Court Below:
	:	Court of Chancery Of the State of Delaware
Defendants Below, Appellants,	:	C.A. NO. 12871-CS
and	:	
SIERRA PROPERTIES LP,	:	
Nominal Defendant below,	:	
v.	:	
NORTH CAROLINA POLICE RETIREMENT FUND, individually and derivatively on behalf of SIERRA PROPERTIES LP,	:	
Plaintiff below, Appellees.	:	

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NATURE OF PROCEEDINGS

This is an appeal by defendant-appellants Sierra GP LLC ("Sierra GP"), Sierra Resources, Inc. ("Sierra Resources"), The Bank of New York Mellon Trust Company, N.A., Sarah W. Bryant, Robert P. Gray, Richard T. Hanson, Elizabeth F. Prince, and John W. Reynolds (collectively, the "Appellants") from the Court of Chancery's ruling in favor of the North Carolina Police Retirement Fund ("NCPRE" or "Appellee") on its cross-motion for summary judgment seeking to invalidate the "Dead Hand Proxy Put" provision in a trust indenture.

Shareholders and creditors are often diametrically opposed to one another. Lenders would rather the corporation enact a conservative business strategy to maximize the likelihood of paying off its debt; conversely, stockholders prefer the corporation to pursue a riskier strategy to maximize potential investment gains. Mark H. Mixon, *Regulating Proxy Puts: A Proposal To Narrow The Proper Purpose Of Proxy Puts After* Sandrigde, 17 U. Pa. J. Bus. L. 1313, 1347 (2015). In order to maintain some sense of risk control, it is not uncommon for creditors to insert some form of change of control provisions in their lending agreements with corporations. These provisions can protect lenders from "involuntarily having to partner with, for example, their competitors; shareholder activists who may have an agenda inconsistent with the objectives of the venture; or other parties that the company would not want to partner or collaborate with[.]" Steven Epstein, *Change-of-Control Protection In Significant Non-Debt Commercial Agreements: The Importance of a Dead Hand Provision*, 19 No. 8 M&A Law. NL 2 (Sept. 2015).One particular change of control provision is the proxy put, which "gives the noteholders the right to put back their debts after a vote that seats a new board that has not been approved by the ousted incumbents." *Kallick v. SandRidge Energy, Inc.*, 68 A.3d 242, 244 n.8 (Del. Ch. 2013). In other words, the lender can accelerate the debt when there is a change of control in the board of directors. A "dead hand" provision of proxy put disables "a board from approving a dissident slate for the purpose of avoiding a triggering of the board change-of-control provision[,]" which would be possible in the absence of a dead hand provision. Epstein, 19 No. 8 M&A Law at 1. *See also San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, 2009 WL 1337150 at *10 (Del. Ch. 2009. Delaware Courts have not made for wholesale invalidation of these provisions, but have cautioned against their adaptation in the shadow of an actual or threatened proxy contest. *See Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, C.A. No. 9789-VCL, at 27:20-28:1 (Del. Ch. Oct. 2014).

On January 20, 2016, NCPRF commenced this action derivatively in the right of Sierra LP arguing that Sierra Resources Board of Directors breached their fiduciary duties by including a change of control provision in a trust indenture, which is *per se* invalid and unenforceable. Sierra Resources countered the provision was included at the instance of the lead underwriter. To date, nno court has ruled on whether a board of directors breaches its fiduciary duties by authorizing indentures that contained change of control provisions.

On January 11, 2017, Appellants filed a timely notice of appeal to this court.

SUMMARY OF ARGUMENT

The Appellee's claims fail on multiple independent grounds.

1. First, the business judgment rule, which should apply in this proceeding, bars duty of care claims. The provision is one for which the firm and the stockholders received substantial economic benefit. Prior precedents, such as *Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, do not support the conclusion that change of control provisions, by themselves, result in a *per se* violation of fiduciary duties.

2. Second, this Court should not follow the *USA Cafes* standard used by the lower court, which indicates that corporate general partners, like Sierra Resources, owe full fiduciary obligations to both the unitholders and to the limited partners. *See In re USA Cafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991). Imposing full fiduciary obligations on Sierra Resources for both their unitholders and the Sierra LP limited partners creates an inequity and perverse incentives for the directors. In essence, the directors of a corporation that have exclusive control over a limited partnership are forced into inaction where a conflict arises in the interests between the two entities. Not only does this create a Catch-22 for any director who seeks to continue to move business resources to their highest valued use, it also creates perverse incentives for recruitment of corporate directors. Delaware Courts have recognized that many of the issues associated with applying the standard set out in *USA Cafes* and have moved toward limiting its scope. Primarily only in those cases involving self-dealing by corporate general partners have judges strictly construed the *USA Cafes* standard against the corporation.

Neither Sierra Resources nor its directors have committed any act that affirmatively or impliedly self-deals; thus, this court should forego a strict application of the *USA Cafes* standard and follow the Chancery Court trend in limiting the scope to self-dealing and bad faith actors.

STATEMENT OF FACTS

A. The Parties

The Appellants include: Sierra Energy Partners LP ("Sierra LP"), Sierra GP LLC ("Sierra GP"), Sierra Resources, Inc. ("Sierra Resources") (collectively, the "Sierra Group"), and the Sierra Resources board of directors Sarah W. Bryant, Robert P. Gray, Richard T. Hanson, Elizabeth F. Prince, and John W. Reynolds (collectively, the "Board")(Mem. Op. at 1) Appellant Sierra Resources operates as a full-service real estate company that acquires, develops and manages office, mixed-use and residential properties nationwide. (Mem. Op. at 4). Sierra Resources sought to capitalize off of what was then a dismal marker for real estate based investments through the formation of a joint venture that would develop, redevelop, and invest in high performance commercial buildings." *Id.* The end result was the formation of Sierra LP, which was funded 80% through capital from the Appellee shareholders, and 20% through capital from Appellant Sierra Resources. *Id.* Sierra Resources acts as the sole member and sole manager of Sierra GP. (Mem. Op. at 3). Sierra GP is the sole general partner of Sierra LP. *Id.* As a result, Sierra Resources and its board exercise "indirect but exclusive control over Sierra LP". *Id.*

B. Sierra Resources Negotiates the Indenture with Lead Underwriter Morgan Stanley.

In 2013 it became apparent that Sierra LP was underleveraged. (Mem. Op. at 5). After consulting with NCPRF and receiving a general endorsement to pursue debt capital, Sierra GP, on behalf of Sierra LP embarked to obtain debt financing. *Id.* On August 15, 2 In 2013 it became apparent that Sierra LP was underleveraged. (Mem. Op. at 5). After consulting with NCPRF and receiving a general endorsement to pursue debt capital, Sierra GP, on behalf of Sierra LP embarked to obtain debt financing. *Id.* On August 15, 2013 Sierra LP completed a public offering for long term 15 year debt. *Id.* The debt had a principal value of $160 million and bearing 2% interest. *Id.* To secure the financing, Appellants entered into a trust indenture ("Indenture"), dated August 16, 2014, that governed Sierra LP's 2% notes (the "Notes") with BNY Mellon as trustee (Mem. Op. at 2). The Notes were 15 year notes, due in 2028 (Mem. Op. at 2). Morgan Stanley served as the lead underwriter for the Indenture and dealt in arms-length negotiations with BNY Mellon and counsel for Appellants Sierra LP and Sierra Resources. *Id.* The Indenture included a change of control provision at the insistence of Counsel for Morgan Stanley (Mem. Op. at 2). Morgan Stanley Counsel indicated, when specifically asked by Sierra Resources directors, that no novel terms were included that would require the attention of the board. (Mem. Op. at 6.)

This traditionally formed indenture successfully secured Sierra LP the "relatively cheap" capital it needed in the form of a 160 million dollar offering. (Mem. Op. at 5.)

At no point between the Indenture and this litigation did an active proxy contest or solicitation for consent occur in regards to the Appellants' business entities. (Mem. Op. at 7). That is to say, the dead hand proxy At no point between the Indenture and this litigation did an active proxy contest or solicitation for consent occur in regards to the Appellants' business entities. (Mem. Op. at 7). That is to say, the dead hand proxy put in the Indenture was enacted on a "clear day."

C. The Change of Control Provision in the Indenture

The Indenture entered into by the parties affords the Noteholders the right, but not the obligation, to accelerate outstanding indebtedness together with an accrued interest upon a "Change of Control." (Mem. Op. at 2).

Section 11.01 of the Indenture provides a change of control occurs if, *inter alia*, "a majority of members of the board of directors…of the parent [Sierra Resources] cease[s] to be composed of individuals (i) who were members of the board…on the first day of [any period of 12 consecutive months], or (ii) whose election or nomination to that board...was approved by individuals referred to in clauses (i) and (ii) above constituting...at least a majority of that board…" *Id.* This right of approval, however, is limited in cases where a director's election or nomination to the board is the result of an actual or threatened proxy contest. *Id.*("excluding…any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors.”)

Morgan Stanley has presented an affidavit stating “that if Section 11.01 had not been included in the indenture, the interest rate on the Notes would have had to have been ‘up to 50 basis points’ higher than 2% for the offering to have succeeded. (Mem. Op. at 9).

D. The Events Leading to this Litigation

In late 2015, High Street Partners, LP (“High Street”) acquired a 6.3% interest in Sierra Resources, triggering the obligation under federal securities law to file a Schedule 13D with the Securities and Exchange Commission. (Mem. Op. at 6). High Street publicly disclosed an intention to propose that Sierra Resources implement a strategy involving a combination of accelerating distributions, selling certain assets, and the potential sale of the company. *Id.* High Street also stated that if High Street failed to implement a strategy satisfactory to High Street, High Street might replace one or more of the directors of Sierra Resources through a contested solicitation of proxies. *Id.*

Following the filing of High Street’s Schedule 13D, Sierra Resources asserted that if High Street nominees constituting a majority of the board were elected, the proxy put in the Sierra LP trust indenture would require Sierra LLP to pay off the Notes, which in turn would require Sierra LP to obtain alternative financing. (Mem. Op. at 7).

NCPRF commenced this action derivatively in the right of Sierra LP on January 20, 2016 claiming the Board breached its fiduciary duties to both NCPRF and Sierra LP.(Mem. Op. at 8).

ARGUMENT

I.THE TRIAL COURT FAILED TO APPLY THE BUSINESS JUDGMENT RULE WHICH BARS APPELLEE'S CLAIMS WITH RESPECT TO THE CHANGE OF CONTROL PROVISION IN THE INDENTURE.

A. Question Presented

Did the Court of Chancery err in failing to apply the business judgment rule and by ruling that change of control provisions result in a per se violation of Delaware law?

B. Scope of Review

An appellate court's review of summary judgment and a "trial judge's legal conclusions" are de novo. *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 836, 841-42 (Del. 2011).

C. Merits of Argument

NCPRF alleges that Sierra Resources breached its fiduciary duties by entering into the Indenture with a change of control provision that *per se* violates Delaware law. The business judgment rule, however, bars the plaintiffs fiduciary duties claim. The business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company." *Aaronson v. Leiws*, 473 A.2d 805, 812 (Del. 1984). "The burden falls upon the proponent of a claim to rebut the presumption [of the business judgment rule] by introducing evidence either of director self-interest, if not self dealing, or that the directors either lacked good faith or failed to exercise due care." *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989).

1. The Business Judgment Rule Protects Sierra Resource's Board's Decisions.

i. The Business Judgment Rule Applies in the Absence of

a Subjective Defensive Measure.

In the absence of defensive measures, Delaware courts review corporate actions under the business judgment rule. *See Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1372 (Del. 1995) ("The Court of Chancery agreed that, had the Board enacted the Repurchase Program independent of a takeover proposal, its decision would be reviewed under the traditional business judgment rule."). Here, NCPRF adopted the Change of Control Provision on a "clear day" – there was no indication from the shareholders that a takeover proposal was ever being considered.

At the trial level, it was an undisputed fact "that [NCPRF] w[as] unaware of the content of [the Change of Control Provision] when the Indenture was entered into." (Mem. Op. at 9). Thus, the actions of the Appellants cannot be deemed "defensive." *See Unocal* enhanced scrutiny in *Gantler v. Stephens*, 965 A.2d 695, 705 (Del. 2009) (where the Court used the business judgment rule as opposed to *Unocal* standard because the specific complaint did not allege any hostile takeover attempt or similar threatened external action from which it could reasonably be inferred that the defendants acted 'defensively.'").

The trial court emphasized in its 2017 ruling that the phenomenon of shareholder activism in the real estate industry was "well known." (Mem. Op. at 6). However, in reaching this conclusion the court only emphasized the effort by Corvex Management that *begun* in 2013, the same year that the Appellants entered into the Indenture. *Id.*

ii. The Business Judgment Rule Should Apply Because there was No Breach of Fiduciary Duty.

The trial court improperly failed to apply the business judgment rule to the conduct of the directors of Sierra Resources. Under Delaware law, a claim of breach of fiduciary duties against a corporate director requires that the plaintiff overcome the business judgment rule. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The business judgment form of judicial review first considers the Board's independence, subjective motivation, and exercise of due care. *In re RJR Nabisco Co. S'holders Litig.*, 1989 Del. Ch. LEXIS 9, at *39 (Del. Ch. 1989). The "entire fairness" standard only becomes relevant if the presumption that directors have acted in good faith and in the best interests of the company is defeated. Until the presumption of the business judgment rule has been rebutted, "the entire fairness inquiry…simply has no application." *Williams v. Geier*, 671, A.2d 1368, 1378 n.20 and 1384 (Del. 1996).

Here, it is not contested that the directors did not act in good faith, as they did not "draft[], advocate[], or [had] even been aware of the existence of the proxy put[.]" (Mem. Op. at 10). Indeed, "the Board of Directors of Sierra Resources specifically inquired whether any provisions of the Indenture were novel terms that required board attention, and the company's outside counsel replied in the negative." *Id.*

"The idea that boards may be acting in their own self-interest to perpetuate themselves in office is, and of itself, the 'omnipresent specter' justifying enhanced scrutiny." *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16. A.3d 48, 94 (Del. Ch. 2011). "The Court looks not only to the reasonableness of the directors' action, but also to the directors' true motives." *In re Novell, Inc. S'holder Litig.*, C.A. No.

6032-VCN (Del. Ch. Nov. 25., 2014), slip op. at 16. Here, it can scarcely be said that the board was acting in its own interest in accepting the dead hand proxy put in the indenture, as "discovery did not reveal that any representative of the Entity Defendants ever suggested or encouraged the inclusion of the provision[.]" (Mem. Op. at 5).

Thus the remaining question is whether the directors were self-interested. To be considered disinterested, directors "can neither appear on both sides of a transaction *nor expect* to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Aronson*, 473 A.2d at 812 (emphasis added). That was simply not the case here. In fact, NCPRF provided the Sierra Resources Board with its general endorsement to embark on an effort to line up debt financing between $150 - $175 million dollars. (Mem. Op. at 10).

2. The Board Did Not Breach Its Duty of Care by Failing to Negotiate over a Term Commonly Found in Indentures and is Entitled to Rely on the Expert Advice of Outside Counsel.

As there is no proof that the Sierra Resource's Directors were involved in self-dealing, conflicts of interest or acted in bad faith, the only other way to bypass the business judgment rule would be to show that the directors breached the duty of care. Corporate directors are presumed to have exercised due care, *Cede & Co. Technicolor, Inc.*, and that presumption will only be overcome by a showing of gross negligence. *Kahn v. Roberts*, 21 Del. J. Corp. L. 674, 684 (Del. Ch. 1995). As the Chancery Court did not find that the directors were grossly negligent, the court improperly used the entire fairness standard of review.

The board was not grossly negligent in failing to negotiate over the Change of Control Provision. To demonstrate a breach of due care, a plaintiff must demonstrate that the directors were grossly negligent or that they took actions that were "without the bounds of reason." *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005)(declining to find gross negligence when the board approved convertible notes offering after consulting with experienced advisors and considering reasonable alternatives).

In the context of a disinterested, independent board committee gross negligence in a due care claim means a "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." *Benihana of Tokyo, Inc.*, 891 A.2d at 192. Thus, NCPRF must show that Sierra Resources' Board was grossly negligent in failing to consider all *material* information reasonably available or that the directors acted without a rationale business purpose. *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000).

However, the law makes clear that due care does not require that the Board be informed of every fact.)*Brehm*, 746 A.2d at 259; *see also Smith v. Van Gorkom*, 488A.2d 858, 883 n.25 (Del. 1985) (noting Directors need not "read *in haec verba* every contract or legal document which they approve"). Rather, the Board is only "responsible for considering *material* facts that are *reasonably available*, not those that are immaterial or out of the board's reasonable reach." *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d at 192(emphasis added).

The Chancery Court asserted that a board may not avoid a due care violation by blaming its expert advisors for keeping them in the dark. (Mem. Op. at 7). This assertion however, conflicts with a long line of settled precedents allowing Boards to reasonably rely on its expert advisors.

It is well established in Delaware that Boards may rely on the advice of expert advisors. *See In Re Citigroup Inc. S'holder Derivative Litig.*964 A.2d 106 132 (Del. Ch. 2009)("[D]irectors of Delaware corporations are fully protected in relying in good faith on the reports of offices and experts.");*In re MONY Group, Inc. S'holder Litig.*, 852 A.2d 9, 21 (Del. Ch. 2004) (holding the board can rely on an officer and need not retain an investment banker to satisfy due care even under heightened standards applicable to change of control.");*Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1142 (Del. 1995) (holding reliance on expert counsel is evidence of "good faith and overall fairness of the process.")

Most recently in *San Antonio Fire & Police Pension Fund v. Amylin Pharms, Inc.*, the plaintiff alleged that the board of directors beached its fiduciary duties when it approved an indenture without knowledge that it contained a continuing director provision. 983 A.2d 304, 307(Del. Ch. 2009) *aff'd en banc* 981 A.2d 1173 (Del.2009). The plaintiff's claim was based largely on the fact that neither the board nor the delegate or pricing committee discovered the provision throughout the approval process. *Id.* at 318.

In determining that the board was not grossly negligent, the

Chancery Court cited that the board of directors relied on highly qualified counsel while also seeking the advice of Amylin's management and investment bankers as to the terms of the agreement. *Id.* The court further noted that the board asked counsel if there was anything "unusual or not customary" in the terms of the convertible to which counsel replied there was not. *Id.* The court noted that "[t]his is not the sort of conduct generally imagined when considering the concept of gross negligence, typically defined as a substantial deviation from the standard of care...Certainly no one suggests that the directors' duty of care required them to review, discuss, and comprehend every word of the 98-page indenture." *Id.* at 318-19.

This Court in Amylin also stressed the significance of inserting a change of control provision on a clear day as it relates to fiduciary duties. *See San Antonio Fire & Police Pension Fund v. Amylin Pharms, Inc.*, 981 A.2d 1173 n.2 (Del. 2009)(ruling in affirmation that board of directors did not breach a fiduciary duty because "no showing was made that approving the 'proxy put' at that point in time would involve any reasonably foreseeable material risk to the corporation or its stockholders.")

The instant case is also not one that comes to mind when "when considering the concept of gross negligence." Similar to *Amylin*, a Sierra Resources Director asked the company's outside counsel if there were any 'novel terms' that required attention from the committee or the board. (Mem. Op. at 6). Outside counsel replied there were not.

Moreover, this court has previously recognized that lenders infrequently invoke the Continuing Director Provision to accelerate the debt on a loan. *See Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, C.A. No. 9789-VCL, at 27:20-28:1 (Del. Ch. Oct. 2014).

3. The Change of Control Provision Serves a Legitimate Business Purpose and Provides a Clear Economic Advantage to Sierra LP and Its Stockholders.

The valid business purpose of the Change of Control Provision cannot be overstated. Inclusion of a change of control provision provides an exit right to creditors who have extended capital to commercial entities based at least in part on current and future business strategy of the borrower. Moreover, state chartered and national banks not only like to know their customer, they now have a *duty* to do so under the Bank Secrecy Act and its implementing regulations. 31 U.S.C. § 5311-5330.

Consequentially, lenders are willing to provide substantial consideration in exchange for the inclusion of this provision. Inclusion of a change of control provision has the ability to significantly lower the cost of debt. *See* Griffith, Sean J. and Reisel, Natalia, *Dead Hand Proxy Puts, Hedge Fund Activism, and the Cost of Capital* (Sept. 2016) (finding that the "inclusion of a Dead Hand Proxy Put reduces the cost of debt by approximately 45 basis points."). Thus, the provision provides significant firm-level benefit by the cost of the loan and thus the companies cost of capital.

The provision was included in the Indenture at the instance of counsel for the lead underwriter. (Mem. Op. at 2). An affidavit from Morgan Stanley recites that if the change of control provision had not been included in the Indenture, the interest rate on the Notes would have been "up to 50 basis points" higher than 2% for the offering to have succeeded. (Mem. Op. at 9). As one basis point is equivalent to 0.01%, 50 basis points is 0.5% percentage points. Thus, the interest rate on the long term 15 year Notes could have been up to 2.5% (a 25 percent increase on the interest rate).

An example demonstrates the substantial potential cost savings at the firm-level from a 0.5% change in interest rates on a long term fifteen year loan. Assuming the loan in the instant case has regular monthly payments, the 0.5% change in interest rate causes the total cost of the loan to go from approximately $185 million to approximately $192 million. Thus, the corporation will save up to $7 million from including the change of control provision.

4. Delaware Courts Oppose *Per Se* Rules.

At the trial court level, NCPRF sought on summary judgment to challenge the validity of Sierra Resource's incorporation of the dead hand proxy put in Indenture through a *per se* rule that would invalidate any type of similar proxy put. Such a ruling would be contrary to precedent in Delaware that disfavors per se rulings. *In re Ancestry.com Inc. S'holder Litig.*, C.A. No. 7988-CS, transcript (Del. Ch. Dec. 17, 2012) ("Per se rulings where judges invalidate contractual provisions across the bar are exceedingly rare in Delaware, and they should be.").

Any notion that dead hand proxy puts are *per se* invalid is misguided. In 2015, the Chancery Court emphasized in *Pontiac General Employees Retirement System v. Ballantine* ("*Healthways*") that the initial denial of the defendants' motion to dismiss *did not* mean that the adoption of the dead hand proxy put was a *per se* breach of fiduciary duties. Transcript of Settlement Hearing at 35 C.A. No. 9789-VCL (Del. Ch. May. 8, 2015 ("[G]iven the facts surrounding the timing of the adoption of the proxy put, as well as the knowledge of these provisions that was outstanding at the time, [] it was reasonable to conceive that the plaintiffs could prevail on their claims.") (referring to Transcript of Oral Argument on Defendants' Motion to Dismiss and Ruling of the Court, C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014).

In that case, the board added the dead hand proxy put provision at issue into a credit agreement after a shareholder proposal to declassify the board of directors: since the provision was "inserted in the shadow of a control contest" the court was highly suspect that the board had entrenchment motives. *Id.*

Conversely, Sierra Resources approved the trust indenture in this case on a 'clear day.' Indeed, "there had been no indication specific to Sierra Resources that any person was planning an election contest to replace one or more of its directors." (Mem. Op. at 6). This distinction is significant. In the *Healthways* settlement hearing, referring to the defendants motion to dismiss Chancellor Laster emphasized that: "One of the factors that was misunderstood about that decision was that it was generally viewed as if it applied to any change-in-control provision, which, frankly, is specious." *Id.*

The trial court erred in going beyond current rulings to establish a new bright line rule that says mere entry into an agreement with this provision is a *per se* breach of fiduciary duty. Because change of control provisions appear frequently in corporate agreements outside of debt instruments, such as employment agreements, intellectual property licensing agreements, joint venture agreements, union contracts, and employee option stock option plans, if the decision is allow stand it could have far reaching adverse ramifications. *See Hills Stores Co. v. Bozic*, 769 A.2d 88, 92 (Del. Ch. 2000)(employment agreements); Grimes v. Donald, 1995 WL 54441, at *4 n.5 (Del. Ch. Jan. 11, 995) (employment agreements); Sutton Holding Corp. v. DeSoto, Inc., 1991 WL 80223, at *1 (Del. Ch. May 14, 1991) (pension plan). This Court should continue to adjudicate the propriety of change of control provisions based on the specific circumstances of their use.

II. THE FIDUCIARY OBLIGATION STANDARD IMPOSED BY THE LOWER COURT SHOULD NOT APPLY TO APPELLANTS BECAUSE THEY ACTED IN GOOD FAITH, WITHOUT SELF-DEALING AND THE IMPOSED STANDARD CREATES PERVERSE INCENTIVES.

A. Question Presented

Did the Court of Chancery properly consider equities and incentives when applying a precedent regarding the fiduciary duties owed to a limited partnership by a corporate general partner where the corporate general partner did not self-deal?

B. Scope of Review

"The formulation of the duty of loyalty and duty of care involves questions of law which are, of course, subject to *de novo* review by [the Delaware Supreme] Court." *Cede & Co. v. Technicolor*, 634 A.2d 345, 360 (Del. 1993) Because the application of the precedent cited by the Court of Chancery below involves a question of law related to the duties of loyalty and care, this court should review the questions of law *de novo*.

C. Merits of Argument

This court should reconsider whether the Appellants should have, equitably, owed certain fiduciary duties to the Sierra LP limited partners. Below, the Court of Chancery applied a standard set forth in *In re USA Cafes, L.P. Litigation*, which held: "one who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner". (Mem. Op. at 11); *In re USA Cafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991). An application of the *USA Cafes* standard to Sierra Resources and its directors fails to consider equity, Court of Chancery tends to limit the standard's scope, and uniformity of the law.

1. Because Inequity and Perverse Incentives Will Directly Result from the Application of the *USA Cafes* Standard to Sierra Resources, the Court Should Forgo its Application.

This court should not apply the *USA Cafes* precedent because it has created an inequitable standard, centered on an unwinnable battle of interests for general corporate partners. *See Gotham Partners, L.P. v Hallwood Realty Partners, L.P.*, 2000 Del. Ch. LEXIS 146, *75 (Del. Ch. 2000); *In re GM Class H S'holders Litig.*, 734 A.2d 611, 618-19 (Del. Ch. 1999). Under the *USA Cafes* standard, corporate general partners owe fiduciary obligations to both the limited partners and to the corporation. *USA Cafes,* 600 A.2d at 48-49. But, in the event that the interests of the limited partnership and corporation diverge, the corporation and its directors can be liable for a breach of fiduciary duty regardless of how they act. *See Gotham Partners*, 2000 Del. Ch. LEXIS 146 at *75.; *GM Class H S'holders*, 734 A.2d at 618-19.

Litigation has surfaced several times since the decision in *USA Cafes* regarding these divergent interests and fiduciary obligations. The Chancery Court in *In re GM Class H Shareholders Litigation* granted summary judgment for corporate directors who exercised exclusive control over a limited partnership and who acted in good faith despite a fiduciary claim against them would have normally fallen under the *USA Cafes* standard. The Court noted that: "An allegation that properly motivated directors, for no improper personal reason, advantaged one class of stockholders over the other in apportioning transactional consideration does not state a claim for breach of the duty of loyalty." *GM Class H S'holders*, 734 A.2d at 618-19. In *Gotham Partners*, the Chancery Court extended this rationale to limited partnership contexts, indicating: "This strand of our corporate decisional law logically extends to the limited partnership context, wherein it will usually be (as in this case) inferable that the limited partners explicitly recognized that the directors of the general partner would be the ones entrusted with balancing the interests of the corporate general partner and its affiliates against the interests of the other unitholders." *Gotham Partners,* 2000 Del. Ch. LEXIS 146 at *74.

Like the corporations involved in *GM Class H Shareholders* and *Gotham Partners,* Sierra Resources fell into this Catch-22. The corporate and partnership interests for Sierra Resources diverged when High Street bought a 6.3% interest in Sierra Resources and threatened to remove directors by proxy vote if Sierra Resources failed to implement its business strategies to satisfaction. (Mem. Op. at 7). As a result, Sierra Resources directors owed fiduciary duties both to its shareholders and to the Sierra LP as the sole owner of Sierra GP, which would force them to make a choice between these interests. (Mem. Op. at 3). Sierra Resources risked the control and, potentially, the financial health, of its corporation if the directors allowed High Street to take hostile control of the business strategy, but the acceleration of the debt after a change in the board would have likely forced the dissolution of Sierra LP. (Mem. Op. at 7). Forcing the Sierra Resources directors to act, but punishing them with litigation when they do, fails to serve the intent of imposing fiduciary obligations—to encourage fair dealing.

Allowing this Catch-22 to continue creates an inequity and perversely incentivizes corporate directors. *Gotham Partners,* 2000 Del. Ch. LEXIS 146 at *75 ("While anyone who serves in such a capacity must expect to deal with the possibility of litigation, it is quite another thing for such a person to accept service that potentially exposes her to a triable claim for breach of the duty of loyalty whenever she makes a good-faith decision about a transaction between the partnership and an affiliate of the general partner."). Because any decision by Sierra Resources would have triggered a breach of the fiduciary duty of loyalty, applying the *USA Cafes* standard here would only serve to prevent well-meaning corporate directors from acting, which would, in turn, restrict the movement of capital and resources to from their highest valued use..

Notably, *USA Cafes* and its progeny have primarily dealt with a set of facts that pointed to bad faith or self-dealing on the part of the corporate directors. See, e.g., *2009 CAIOLA Family Trust v. PWA, LLC*, 2015 Del. Ch. LEXIS 262 (Del. Ch. 2015); *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012). In fact, the logic of the court in *USA Cafes* relied on a hypothetical that involved a corporate general partner engaged in self-dealing. *See USA Cafes,* 600 A.2d at 48-49. While Delaware Chancery Courts have upheld the *USA Cafes* standard in self-dealing cases, Delaware Chancery Courts have also consistently found inequity in duty of loyalty breach cases where the corporate directors acted in good faith. *See Gotham Partners*, 2000 Del. Ch. LEXIS 146, *72 (noting that the directors did not act in a bad faith or self-interested manners and were not liable for a breach of loyalty); *GM Class H S'holders*, 734 A.2d at 619 (finding that the corporate general party did not act self-interestedly or breach the duty of loyalty). Sierra Resources had no knowledge of the unique consequences this provision would have and did not receive any benefit or kickback from the inclusion of the provision. (Mem. Op. at 6). As such, no evidence of self-dealing or bad faith on the part of Sierra Resources or its directors exists and this court should not feel beholden to the *USA Cafes* precedent.

It appears from the language of some *USA Cafes* progeny that "the entities who control the general partner owe the limited partners at a minimum the duty of loyalty…". *Feeley*, 62 A.3d at 670. An equally clear pattern emerged from the Courts of Chancery that limited the scope of the *USA Cafes* standard to instances involving self-dealing, which will allow this court to clarify or modify the precedent. *See, e.g., Gotham Partners,* 2000 Del. Ch. LEXIS 146 at *75; *GM Class H S'holders*, 734 A.2d at 618-19.

The presence of this quasi-exception for self-dealing in the Delaware Chancery Court has slowly chipped away at the scope of the *USA Cafes* standard and this gradual divergence has left the law relatively unsettled. To resolve the inequity imposed on corporate general partners, this court should consider the inequities and perverse incentives tolerated by the *USA Cafes* standard and depart from it.

CONCLUSION

In the decision leading to this appeal, the Court of Chancery made two errors of law that can be corrected in this *de novo* review. First, the Court of Chancery failed to apply the business judgment rule to Sierra Resources regarding the Indenture's Change of Control provision. Second, the Court of Chancery applied an inequitable and likely incorrect precedent to Sierra Resources. For these reasons, this Court should reverse the Chancery Court opinion below.