IN THE SUPREME COURT OF THE STATE OF DELAWARE

NORTH CAROLINA POLICE RETIREMENT FUND, individually and derivatively on behalf of SIERRA PROPERTIES LP,	:	
Appellants, Plaintiff Below,	:	No. 12871-CS
v.	:	
SIERRA GP LLC, SIERRA RESOURCES THE BANK OF NEW YORK MELLON TRUST, N.A., SARAH W. BRYANT, ROBERT P. GRAY, RICHARD T. HANSON, ELIZABETH F. PRINCE, and JOHN W. REYNOLDS,	:	
Defendants,	:	
and	:	
SIERRA PROPERTIES LP,	:	
Nominal Defendant.	:	

APPELLEE'S REPLY BRIEF

Filed by Team R,
Counsel for the Plaintiffs Below Appellee
Dated: February 3, 2017

TABLE OF CONTENTS

Page

TABLE OF CITATIONS....................iii

NATURE OF PROCEEDINGS....................1

SUMMARY OF THE ARGUMENT....................2

STATEMENT OF FACTS....................2

ARGUMENT....................4

I. THE COURT OF CHANCERY CORRECTLY HELD THAT THE BOARD VIOLATED DELAWARE LAW BY ADOPTING THE "DEAD HAND PROXY PUT" PROVISION OF SIERRA LP'S INDENTURE WITH NOTEHOLDERS........4

A. Question Presented....................4

B. Scope of Review....................4

C. Merits of the Argument....................4

1. The Section 11.01 'proxy put' per se violates Delaware law by depriving Sierra Resources' incumbent board of directors of any ability to avoid triggering the Noteholders' put rights by approving the election of persons nominated in connection with an election contest....................5

a. The board's failure to learn of the existence of Section 11.01 does not excuse its breach of its fiduciary duties to shareholders................7

b. The Section 11.01 proxy put violates Delaware law by impermissibly interfering with directors' statutory power....................9

2. The dead hand proxy put serves as an unjustifiable defensive measure....................9

a. The board failed to provide compelling justification for its adoption of Section 11.01 of the Indenture, required under *Blasius* because of the provision's impairment of the shareholder franchise....................10

b. Under *Unocal*, the board failed to identify a reasonable threat and responded disproportionately................................14

c. The board's adoption of the proxy put fails entire fairness review.................................15

II. THE COURT OF CHANCERY CORRECTLY RULED THAT GENERAL PARTNERS OWE THEIR LIMITED PARTNERS FIDUCIARY DUTIES UNDER DELAWARE LAW..18

A. Question Presented...................................18

B. Scope of Review......................................18

C. Merits of the Argument...............................18

1. Delaware law is consistently clear that general partners owe fiduciary duties to limited partners...................................19

a. Delaware law requires an express or implicit agreement to intentionally use property to the detriment of a limited partnership................20

b. Contractual duties are insufficient to protect limited partners from unfair and abusive transactions.....................................21

2. Even if the Defendants did contract out of their fiduciary duties, the duties of care and loyalty and the implied covenant of good faith still govern the relationship.....................22

a. Sierra Resources GP did not explicitly shield themselves from the duty of care, but only from monetary damages.............................22

b. The limited partnership arrangement does not waive the duty of loyalty........................23

c. An implied covenant of good faith exists to govern the contractual relationship even without fiduciary duties.............................24

CONCLUSION..25

TABLE OF CITATIONS

DELAWARE SUPREME COURT CASES: Page(s):

Gerber v. Enterprise Products Holdings, 67 A.3d 400 (Del. 2013)..22,24-25

Gatz Props. v. Auriga Capital Corp., 59 A.3d 1206 (Del. 2012)....23

Gotham Partners v. Hallwood Partners, 817 A.2d 160 (Del. 2002)...20

MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003)..12

Progressive N. Ins. Co. v. Mohr, 47 A.3d 492 (Del. 2012).........18

Smith v. Van Gorkam, 488 A.2d 858 (Del. 1985)....................6

Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).....4,13

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)...11, 13, 14-5

Weinberg v. UOP, Inc., 457 A.2d 701 (Del. 1983)..................24

DELAWARE CHANCERY COURT CASES:

Bay Center Apartments Owner v. Emery Bay PKI, 2009 WL l124451 (Del. Ch. 2009)...21-2

Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988)..10-1, 13-4

Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998)...........9,12

Dieckman v. Regency GP LP, 2016 WL 1223348 (Del. Ch. 2016).......20

Feeley v. NHAOCG, 62 A.3d 649 (Del. Ch. 2012)....................20

Gerber v. Enterprise Products Holdings, 2012 WL 34442 (Del. Ch. 2012)..22

In re USA Cafes, L.P. Litig., 600 A.2d 43 (Del. Ch. 1991)........19

Kallick v. SandRidge Energy, Inc., 2013 WL 868942 (Del. Ch. 2013)...6

Lonergran v. EPE Holdings, 5 A.3d 1008 (Del. Ch. 2010)...........22

San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc., 983 A.2d 304 (Del. Ch. 2009)..........................6

Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989)..15

Werner, M.D. v. Miller Technology Management, L.P., 831 A.2d 318 (Del. Ch. 2003)...23

DELAWARE STATE STATUTES:

8 Del. C. § 141(a)...9

NATURE OF PROCEEDINGS

On August 16, 2013, Sierra Energy Partners LP ("Sierra LP") entered into a trust indenture with Noteholders containing a "dead hand proxy put" provision. The Indenture provides that, upon a "change of control" of the board as defined, Noteholders' put rights are triggered, immediately accelerating Sierra LP's liabilities to Noteholders. Under the provision, directors lack the power to avoid the Noteholders' put rights from being triggered. The North Carolina Police Retirement Fund, which holds 80 percent of Sierra LP's limited partnership interest, sued individually and derivatively on behalf of Sierra LP, claiming that this provision *per se* violated Delaware law. Sierra LP, Sierra GP LLC ("Sierra GP"), and Sierra Resources, Inc. ("Sierra Resources") filed a motion to dismiss the complaint, and plaintiff filed a cross-motion for summary judgment. Because defendants presented matters not included in plaintiff's complaint, the Court of Chancery treated defendants' motion to dismiss as a motion for summary judgment and allowed limited discovery. Agreeing that there are no genuine issues of material fact, plaintiff presented a cross-motion for summary judgment. Separately, the defendant-directors of Sierra Resources joined the above defendants motion to dismiss turned summary judgment. The Court of Chancery denied defendants' motions and granted plaintiff's cross-motion for summary judgment. Defendants submitted notice of appeal to this Honorable Court on January 11, 2017.

SUMMARY OF ARGUMENTS

I. The Court of Chancery was correct in finding that the "proxy put" provision of the Indenture violated Delaware law and must be invalidated. The provision breaches directors' fiduciary duties by placing the interests of Noteholders above shareholders and violates Delaware law regarding directors' authority. The financial implications of triggering the proxy put serve as a defensive measure entrenching the board in power and interfere with the shareholder franchise. The board offered no compelling justification for this interference, nor did the board identify any plausible threat to the company that may have warranted this defensive measure. Failing stricter review, the economic realities of the proxy put illustrate that the transaction was not entirely fair.

II. The Court of Chancery was correct in their ruling that general partners owe their limited partners fiduciary duties under Delaware law. Sierra Resources GP failed to explicitly gain permission from their limited partner to use resources on their behalf in a way that did not harm Sierra Resources LP. Though certain fiduciary duties were contractually eliminated, the remaining protections are insufficient to ensure fairness to limited partners. Sierra Resources GP did not unambiguously contract out of the duty of care, cannot eliminate the duty of loyalty, and a covenant of good faith and fair dealing still remains in place.

STATEMENT OF FACTS

On August 16, 2013, Sierra LP entered into an Indenture with Noteholders that contained a "dead hand proxy put" provision. This

proxy put is triggered by a change of control of the board of directors; namely, Section 11.01 triggers Noteholders' put rights upon the assumption of office of a majority of the board occurring as "a result of an actual or threatened solicitation of proxies." Once triggered, Noteholders have the right to require Sierra LP to pay them their entire principal and any accrued interest in cash immediately. The parties agree that the triggering of Noteholders' put rights would cause a direct financial impact on Sierra LP of roughly $10-15 million. Significantly, Section 11.01 of the Indenture removes the incumbent directors' ability to avoid triggering the Noteholders' put rights by approving the election of persons nominated in connection with a proxy contest.

While no party has sought to replace one or more of the directors of Sierra Resources through a proxy contest, High Street Partners, LP, an activist hedge fund, has acquired a small stake in Sierra Resources and has threatened that it may seek to replace members of the board in the future. Sierra Resources has conceded that if High Street, or any other party, is able to replace a majority of the board through an actual or attempted proxy contest, the proxy put will be triggered with no recourse from the incumbent or future board of directors.

Alleging that the proxy put as framed in the Indenture *per se* violates Delaware law, plaintiff, a pension fund owning an 80 percent stake in the limited partnership interest of Sierra LP, filed a complaint and motion for summary judgment in the Delaware Court of Chancery. The Court of Chancery held in favor of the plaintiff. Defendants then appealed to this court.

ARGUMENT

I. THE COURT OF CHANCERY CORRECTLY HELD THAT THE BOARD VIOLATED DELAWARE LAW BY ADOPTING THE "DEAD HAND PROXY PUT" PROVISION OF SIERRA LP'S INDENTURE WITH NOTEHOLDERS.

A. QUESTION PRESENTED

Whether the board's use of a "dead hand proxy put" must be invalidated because it violates Delaware law by depriving Sierra Resources' incumbent board of any ability to avoid triggering the Noteholders' put rights and serves as an unjustifiable defensive measure.

B. SCOPE OF REVIEW

The Delaware Supreme Court reviews the legal conclusions of the Court of Chancery *de novo*. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1385 (Del. 1995).

C. MERITS OF THE ARGUMENT

The provision of Section 11.01 of Sierra LP's Indenture with Noteholders depriving Sierra Resources' incumbent board of any ability to avoid triggering the Noteholders' put rights violates Delaware law and must be invalidated. This provision (hereinafter the "proxy put") forces directors to breach their fiduciary duties by placing the interests of Noteholders above those of shareholders, especially given the possible severe financial repercussions of the put rights being triggered. The board's approval of the proxy put conflicts with their mandate under Delaware law to manage the business and affairs of the company. The board's attempt to excuse its breach of fiduciary duties to shareholders by arguing that it was not aware of the provision at issue merely serves to highlight the lack of care with which the board

proceeded in negotiating this important financial event for Sierra LP. At the same time, the nature of the proxy put serves to defend Sierra LP and entrench the current board of directors in power because of the strong financial disincentives created for voting in favor of a proxy challenger. Because the election of a majority of directors via proxy contest will trigger the Noteholders' put rights, with no recourse available from the current board, shareholders' core power in the company to elect directors is interfered with. The board offered no compelling justification for this interference on the shareholder franchise. The board also failed to identify any plausible threat to the company that may have warranted this defensive measure. Finally, the basic economic realities of the severity of the financial impact of the triggering of the put rights compared to any possible increased cost of capital outweigh arguments made by the board that the proxy put was entirely fair. The confluence of these factors mandates that Sierra LP's dead hand proxy put provision be invalidated.

1. **The Section 11.01 'proxy put' per se violates Delaware law by depriving Sierra Resources' incumbent board of directors of any ability to avoid triggering the Noteholders' put rights by approving the election of persons nominated in connection with an election contest.**

By approving the Section 11.01 proxy put, the board violated Delaware law by breaching its fiduciary duties to shareholders by impermissibly interfering with the power directors are assigned by statute. With the inclusion of the dead-hand proxy put in Section 11.01, the board stripped itself of the ability to approve, even for proxy put reasons, nominees to the board made via proxy contest,

thereby stripping itself of the ability to avoid the proxy put being triggered. As evidenced in cases such as *Amylin Pharmaceuticals*, in companies with indentures including proxy put provisions, the board has the power to approve slates of nominees to the board via proxy solely to avoid triggering a proxy put. *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, 983 A.2d 304, 307-308 (Del. Ch. 2009). In fact, company boards generally not only have the ability approve nominees made by proxy, but rather they have the fiduciary duty to approve such nominees in this manner. *Kallick v. SandRidge Energy, Inc.*, 2013 WL 868942 (Del. Ch. 2013) (holding that the board would be breaching its duty of loyalty by failing to approve the rival slate for purposes of the poison proxy put).

By voluntarily stripping itself of this power by including the proxy put in the Indenture, the board per se breached its fiduciary duties to shareholders by placing the interests of Noteholders above those of the shareholders. The directors' fiduciary duties flow to the shareholders; directors owe no fiduciary duty to creditors. *See Smith v. Van Gorkam*, 488 A.2d 858, 872 (Del. 1985). This provision, in effect, gives the Noteholders themselves a better chance of affecting their repayment of principal and accrued interest than directors; the board has no way to prevent the triggering of the proxy put, while Noteholders theoretically could assist in the election of a majority of new directors via proxy contest, thereby triggering the proxy put. Additionally, by approving the proxy put, the board lessens some of the Noteholders' risk: they need not fear the impacts of a proxy

contest since the put will be triggered without recourse from the board.

In exchange for these generous terms to the Noteholders, the board received little to nothing in return. The Noteholders would have provided Sierra LP capital regardless, only at a slightly higher interest rate. As will be discussed in more detail below, according to the board's underwriter, without these generous terms, Sierra LP might have had to pay "up to 50 basis points" more in interest. Notwithstanding the ambiguous impact of a statement couched in the terms "up to," even an increase of 50 basis points in the interest rate on the Notes would not have been adequate consideration for terms that place Noteholders in more control, with less risk, than equity holders. Sierra LP was not in a position of life or death for the venture, where a lack of immediate capital on whatever terms possible was necessary.

a. The board's failure to learn of the existence of Section 11.01 does not excuse its breach of its fiduciary duties to shareholders.

In financially significant matters impacting shareholders, to whom directors owe fiduciary duties, directors cannot and should not be able to escape liability by merely retaining counselors and asking sparse questions. *See Amylin Pharmaceuticals*, 983 A.2d at 319. Directors maintained a responsibility to actively consider the impact on shareholders despite the offering being one for Noteholders. A debt offering, if it goes poorly, can still have a dramatic negative impact on equity holders, for example, if the company defaults. Moreover, when negotiating a debt instrument, directors must take detailed note

of their fiduciary duties, for they are negotiating with rights that first and foremost belong to equity holders and are negotiating against a group whose interests may often be adverse to those of equity holders. *Id*. Considering the potential interest to and conflict with shareholders resulting from the debt offering, combined with the fact that this debt offering was valued at 160 percent of the equity of Sierra LP, this significant financial event for the company required greater care to be exercised by directors in their approval of the Indenture.

The board's argument that they did not create and had no awareness of the proxy put, and therefore could not have breached any fiduciary duties, fails because as a fiduciary, they hold the ultimate responsibility for agreements the company reaches that impact the shareholders. By approving the Indenture containing the proxy put, the board ratified the proxy put. The board's lack of awareness of the proxy put is not an exculpation of the board's breach towards shareholders, but rather a condemnation of its lack of care. Although the board attempts to excuse itself by explaining that it took no action as a fiduciary, by approving the Indenture that is exactly what the board did. Attempting to shift blame to its financial underwriter, the board cannot take advantage of the "incumbency-reinforcing effects of Section 11.01," as the lower court describes, while harming the interests of shareholders. Concerns of equity dictate that although the Indenture serves as a contract with a third party, the potential harms to shareholders and the importance of fiduciary duties within corporate law outweigh the pitfalls of limiting this provision of

Section 11.01 to allow the board to approve a proxy slate for the purpose of avoiding triggering the proxy put.

b. The Section 11.01 proxy put violates Delaware law by impermissibly interfering with directors' statutory power.

The provision of the proxy put stripping directors of the right to approve nominees in a proxy contest even for purposes of avoiding triggering the put rights impermissibly interferes with the powers granted directors in Delaware law. The Delaware Code mandates that the directors "shall" manage the business and affairs of the corporation. 8 Del. C. § 141(a). This mandate holds unless the company says otherwise in its certificate of incorporation. *Id.* Given no evidence that the Sierra Resources certificate of incorporation curtailed its directors' powers, by removing themselves of the power to fully manage the business and affairs of the company by eliminating their ability to prevent the acceleration of $160 million of the company's debt, the directors impermissibly interfere with the Delaware Code. The dead hand proxy put therefore interferes with the board's power to protect fully the company's and its shareholders' interests in a very consequential financial event in the life of a business. *See Carmody v. Toll Bros*., 723 A.2d 1180, 1195 (Del. Ch. 1998).

2. The dead hand proxy put serves as an unjustifiable defensive measure.

By approving an Indenture that includes a provision imposing a substantial financial penalty on the company in the event of a change in control of the board as a result of a proxy challenge, the board created a defensive measure that operates to entrench itself in power

and interferes with the shareholder franchise and therefore must be analyzed under stricter standards of judicial review. The board interfered with the shareholder franchise by strongly disincentivizing the success of any future proxy challenge. The proxy put remains an unjustifiable defensive measure, as detailed below, despite the lack of any specific potential proxy challenge or activist position in Sierra LP at the time the indenture was entered into. As the Chancery Court notes, shareholder activism in the real estate industry was a known phenomenon and a board's implementation of defense measures before the emergence of a challenger does not diminish their defensive nature.

Both the interference with the shareholder franchise and the use of defensive measures requires a stricter judicial standard of review and, upon failing these standards, must be viewed under the entire fairness standard.

a. **The board failed to provide compelling justification for its adoption of Section 11.01 of the Indenture, required under *Blasius* because of the provision's impairment of the shareholder franchise.**

The strong disincentives created by the proxy put for shareholders for voting for a proxy challenger impede on the shareholders' franchise, requiring the board's action in approving the proxy put to be reviewed under the *Blasius* standard. *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). The proxy put of the Indenture makes a change in control of the board via a proxy contest substantially more expensive. This added expense serves as a form of "poison pill," which makes Sierra LP a less

attractive target because of the added financial strain the company will face as a result of a proxy contest. Under a typical poison pill, a board generally has the ability to "redeem" a pill and circumvent its negative effects. Here, however, the parenthetical clause of the Section 11.01 (excluding individuals joining the board as a "result" of an "actual or threatened" proxy contest) deprives the board from making any sort of redemption of this proxy put—Noteholders' put rights are triggered upon change of control via proxy contest with no recourse to the board. Such severe financial implications further disincentivize shareholders from voting in favor of a challenger to the board. Limiting this fundamental avenue of shareholder sentiment demands an analysis of the board's adoption of the Indenture containing Section 11.01 under *Blasius*.

Blasius asks two key questions: First, is the defensive measure adopted for the primary purpose of interfering with or impeding the shareholder vote? This requires determining whether the measure was coercive or preclusive, or whether a challenger would have a reasonably attainable prospect of prevailing. Second, if the defensive measure is preclusive, is there compelling justification for it? If there is no compelling justification, then the preclusive measure should be invalidated. If there is compelling justification, analysis can proceed to the reasonableness analysis of *Unocal*. *Id.*

Despite the board's contention that they were relatively uninvolved with the inclusion of Section 11.01, the proxy put remains a defensive measure adopted for the primary purpose of interfering with the shareholder vote. A measure can be deemed to have a primary

purpose of interfering with the shareholder vote simply by affecting the significance or impact of such a vote. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132 (Del. 2003). Because of the difficulties associated with assessing motive, this test is primarily outcome determinative. *Id.* While the board or its underwriter may contend that the provision's purpose was to mitigate risk to Noteholders or to reduce the company's interest rate on the notes, fundamentally, these arguments merely mask the fact that risk and interest rates are only mitigated by preventing a change in control of Sierra LP. Otherwise, if the board, negotiating with the Noteholders, had not sought to prevent shareholders from voting for challengers in a future proxy contest, they would have not sought to include the provision in the Indenture.

Section 11.01 of the Indenture disenfranchises shareholders by forcing them to vote against any non-incumbent director if shareholders seek to be represented by a board entitled to avoid steep financial penalties and fully exercise its fiduciary duties. This makes the "dead hand proxy put" coercive. *Cf. Carmody v. Toll Bros.*, 723 A.2d 1180, 1195 (Del. Ch. 1998). Section 11.01 also "makes an offer for the Company much more unlikely since it eliminates use of a proxy contest as a possible means to gain control," *see id.*, because any majority of directors joining the Board as a "result" of an "actual or threatened solicitation of proxies" could trigger the financial penalties of the Noteholders' put rights. This renders future contests for corporate control of Sierra LP "prohibitively expensive and effectively impossible." *See id.* "A defensive measure is

preclusive if it makes a bidder's ability to wage a successful proxy contest and gain control either 'mathematically impossible' or 'realistically unattainable.'" *Id.*, quoting *Unitrin*, 651 A.2d 1361, 1388-89 (Del. 1995). Although a challenger's odds of success in a proxy contest would not be mathematically impossible, the financial penalty of success for Sierra LP would cause reasonable shareholders to avoid voting for a proxy challenger and make their success "realistically unattainable" and the board's action of entering into the Indenture containing Section 11.01 preclusive.

Despite the board's contention in the lower court that the lack of the proxy put could have caused the interest rate on the Notes to have been "up to 50 basis points" higher, the board fails to provide compelling justification under *Blasius* for interfering with the shareholders' franchise. Although "compelling justification" has not been well defined by the courts, the standard requires strict scrutiny of compelling justification *with regards to this particular threat*. As will be further discussed in the *Unocal* analysis in the following section of this brief, the board explicitly concedes it never contemplated a threat to the corporation. This necessarily implies a lack of compelling justification for including this defensive proxy put. Even if the board had articulated a threat to the corporation (such as a threat to the effectiveness of their corporate strategy by an activist), the preclusive aspects of the proxy put prove justification of its inclusion to not be compelling under the *Blasius* standard. The board, in effect, argues that the *possibility* that the interest rates on the Notes *could have* been *up to* 50 basis points

higher, in an environment described by the lower court offering "relatively cheap" new debt capital, outweighs the interference with the shareholder franchise caused by the inclusion of Section 11.01. The fundamental concept of unimpeded shareholder voting in corporate law cannot and should not be outweighed by the possibility of a slightly increased interest rates on long-term debt financing entered into voluntarily.

b. Under *Unocal,* the board failed to identify a reasonable threat and responded unreasonably.

Even in the event that the Court finds the board's interference with the shareholder franchise not to be preclusive under *Blasius*, the board's defensive measure must still be invalidated for failing to withstand review under *Unocal*. Although no hostile bid has been made against Sierra LP, in the absence of the stricter *Blasius* review, *Unocal* is the appropriate standard of review in the event of a defensive measure employed to prevent any possible future change in control. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). By approving an Indenture that includes a provision imposing a substantial financial penalty on the company in the event of a change in control of the board as a result of a proxy challenge, the board created a defensive measure designed to entrench itself in power and that must be analyzed under a *Unocal* analysis. As explained previously, the defensive nature of the board's action is unaffected by the fact that at the time of the board's approval there was no specific activist threat.

The board fails to identify a reasonable possible threat to corporate strategy or effectiveness that may give it cause to adopt an *ex ante* defensive measure, *Unocal's* first prong, *see id*, because they failed to identify any threat. As the lower court details, the board explicitly emphasizes the fact that they were unaware of the contents of 11.01 when the Indenture was entered into and therefore necessarily cannot have been responding to a reasonable perception of a threat to the company when they approved Section 11.01.

Even if the board had identified a reasonable threat to the company, their defensive measure would likely fail to be proportionate. *See id.* Because the relevant clause of Section 11.01 goes so far as to trigger the proxy put as a result of any change in control relating to a proxy contest, without any fiduciary out for the board or any other means of avoiding this financial penalty, and by doing so in a way that arguably improperly interferes with the shareholders' franchise, there are few possible threats that could reasonably merit such a defensive response. As the board failed to articulate any reasonable threat to the company, such a defensive measure is inappropriate under *Unocal* and must be invalidated.

c. The board's adoption of the proxy put fails entire fairness review.

As a consequence of the board's failure to apply a *Unocal* analysis, the provision of the Indenture at issue should be scrutinized against the entire fairness standard rather than the business judgment rule. *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 271 (Del. Ch. 1989). Satisfying the entire fairness standard

requires the board to prove that both in its financial practices and its dealings that it acted fairly, in effect requiring that no harm have been done to the company. *Id. at 272-76.*

Directors' own statements made in the wake of the Schedule 13D filed by High Street Partners, informing investors and the press that the election of High Street nominees constituting a majority of the board would trigger the proxy put and financially impact Sierra LP, discredit directors' claim that Section 11.01 of the Indenture was entirely fair. The possible financial impact on Sierra LP upon the triggering of the proxy put, possibly "catastrophic" to equity holders if alternative financing cannot be arranged, emphasizes the lack of entire fairness; the very structure of Section 11.01 removes any ability of even the incumbent board to avoid triggering the proxy put in the event of a majority of the board being elected via proxy contest. The fact that Sierra LP is now at risk of a financial penalty (the triggering event), without any recourse from the board, from notes due only in 2028, highlights the lack of entire fairness present in this Indenture.

The board's argument in favor of entire fairness fails the mathematical realities of the offering and possible triggering of the proxy put. The board asserts that had Section 11.01 not been included in the Indenture, the interest rates on the Notes would have been "up to 50 basis points" higher than the interest rate of two percent that Sierra LP received. As the lower court noted, the board fails to offer any proof that the inclusion of Section 11.01 avoided any specific additional interest cost; "up to" 50 basis points higher includes the

possibility that the interest rate would not have been any higher at all. However, assuming, *arguendo*, that Sierra LP's interest rate on the Notes actually would have been 2.5 percent, the proxy put would continue to fail entire fairness review due to the potential financial penalty if the proxy put is triggered, which outweighs the increased cost of capital. Under the current two percent interest rates on the $160 million of Notes, Sierra LP owed Noteholders a total of $3.2 million. With a 2.5 percent interest rate, accepting Morgan Stanley's highest possible figure for the sake of argument, Sierra LP would owe Noteholders a total of $4 million, $800,000 more than the current interest total. This $800,000 increase in the cost of capital had Section 11.01 not been present is still dramatically outweighed by the potential financial impact of the triggering of the proxy put. While the proxy put is not certain to be triggered, the board has no control over if or when it might be triggered. The board concedes that the direct financial impact on Sierra LP if the proxy put is triggered would be five times greater than the indirect impact on Sierra Resources, which Sierra Resources asserted could range from two to three million dollars. Therefore, the possible financial impact on Sierra LP of the proxy put when triggered, $10-15 million, far outweighs the highest possible difference in the interest rate without Section 11.01, $800,000, and therefore proves that this transaction was not entirely fair.

The proxy put's disproportionately defensive posture without justification, as well as the economic reality showing that the possibly financial consequence of the put rights being triggered far

outweighs the possible increased cost of capital, highlight that the proxy put must be invalidated for failing to be sustained under any applicable standard of review.

II. THE COURT OF CHANCERY CORRECTLY RULED THAT GENERAL PARTNERS OWE THEIR LIMITED PARTNERS FIDUCIARY DUTIES UNDER DELAWARE LAW.

A. QUESTION PRESENTED

Whether Defendant Sierra GP and Individual Defendants Bryant, Gray, Hanson, Prince, and Reynolds owe a fiduciary duty to Plaintiff Sierra Properties LP related to their negotiation of Section 11.01 even though the plaintiff is only a limited partner under Delaware law and the defendants contracted to eliminate their fiduciary duties as general partners in the LP agreement.

B. SCOPE OF REVIEW

The Delaware Supreme Court reviews a trial court's legal conclusions de novo. *Progressive N. Ins. Co. v. Mohr*, 47 A.3d 492, 495 (Del. 2012). The underlying issue requires a legal interpretation of whether fiduciary duties apply to limited partners, which is a question of law, and therefore does not require the Court provide deference to lower court's conclusions of law. *Id*.

C. MERITS OF THE ARGUMENT

Delaware law has consistently held that general partners cannot use corporate resources at the expense of their partnership agreements. Without an explicit agreement, the limited partner is entitled to fiduciary protection under their partnership agreement. Sierra Resources did not explicitly receive permission to negotiate this term because of defects in the negotiation process that were

unfair, including joint counsel and failure to identify novel terms that unduly affected the limited partner's shareholder franchise. Leaving fiduciary duty analysis to contractual interpretation is too ambiguous and does not provide sufficient guidance to corporate actors in the face of uncertainty in their own partnership agreements.

Even if the general partner successfully contracted out of their default fiduciary duties, the implied covenant of good faith as well as the duty of loyalty still apply. Additionally, only monetary damages were excluded for the duty of care. As a result, the duty of care still applies to govern the general partner's conduct with respect to their limited partner. Sierra Resources GP did not provide adequate care in reviewing the contractual terms of this arrangement, especially since it creates a strong disincentive to vote on proxy change of control matters. Further, implied covenant of good faith requires courts to examine what the parties would have agreed to within their reasonable expectations. It is inconceivable that the limited partner would have agreed to limit their shareholder franchise in this way, even for a better interest rate on their note.

1. **Delaware law is consistently clear that general partners owe fiduciary duties to limited partners.**

General partners have fiduciary duties to their limited partners. Delaware law requires general partners "not to use control over the partnership's property to advantage the corporate director at the expense of the partnership." *In re USA Cafes, L.P. Litig., 600 A.2d 43, 49 (Del. Ch. 1991)*. If the Court rules consistently with precedent, it follows that Sierra GP at common law has fiduciary

duties to its limited partner Sierra LP. This court has raised a “note of concern and caution” where the law allows limited partnership agreements to eliminate fiduciary duties of a general partner. *Gotham Partners v. Hallwood Partners, 817 A.2d 160, 167 (Del. 2002).* Other lower courts have held similarly where defendants argued no fiduciary duties exist to their limited partners. *See, e.g., Feeley v. NHAOCG, 62 A.3d 649, 671 (Del. Ch. 2012); Dieckman v. Regency GP LP*, 2016 WL 1223348, at *10.

a. Delaware law requires an express or implicit agreement to intentionally use property to the detriment of a limited partnership.

To determine if a general partner’s detrimental activity with respect to a limited partner is legal, a court must look to find an express or implicit agreement between the parties. *600 A.2d* at 49. Further, when limited partners will receive “grossly inadequate” outcomes following the use of their resources to the benefit of a general partner, the transaction may fail judicial scrutiny. *Id* at 50. In *Feeley*, the Court of Chancery found that default fiduciary duties do apply in situations where corporate resources have been diverted by a manager-member of an LLC from the entity to another business. *62 A.3d* at 652. In the case, the manager of an investment capital group was grossly negligent in passing investment opportunities to other self-interested business opportunities. *Id*. Without an explicit agreement for this arrangement, the member had breached its default fiduciary duty.

Sierra Resources GP created an investment vehicle through their limited partnership agreement that would ultimately be to their

benefit. The use of note funding to invest in real estate and the required "change of control" provision helped secure the deal on behalf of the general partnership. Similar to *Feeley*, the general partner enlisted the other entity's corporate resources and commitment for their own business benefit. The ruling in *USA Cafes* prohibits the use of the partnership's property to benefit the partner in control – in this case Sierra Resources GP. This ruling has been consistently followed across Delaware courts and protects against abusive general partner conduct.

b. Contractual duties are insufficient to protect limited partners from unfair and abusive transactions.

Default fiduciary duties are necessary to provide adequate protections to limited partners who face misuse of their corporate resources by general partners. Too much ambiguity exists in contractual terms to determine what fiduciary duties may have been limited or eliminated. *See* 2009 WL 1124451 at *2. In *Bay Center Apartments Owner*, an unclear operating agreement between the plaintiff and defendant resulted in ambiguity as to which fiduciary duties applied. *Id*. Often, parts of the operating agreement contradicted itself causing confusion and an inability for corporate managers to comport with their legal duties.

In this case, Sierra Resources GP was under the impression that their fiduciary duties were eliminated in certain respects under the limited partnership agreement. Though Section 11.01 is a term contracted between the two parties, it is unclear which fiduciary duties are left to comply with. Had there been more certainty, the

general partner's behavior may have been more beneficial to their limited partners. Instead, they operated under the assumption that the duties were not default, leaving courts to determine and predict what parties would have agreed to after the fact. Fiduciary duties are too important to leave to the unpredictability of contract interpretation.

2. **Even if the Defendants did contract out of their fiduciary duties, the duties of care and loyalty and the implied covenant of good faith still govern the relationship.**

Though the General Partners claim to have limited or eliminated their monetary liability for breach of the duty of care, other fiduciary duties still exist that govern the relationship. General partners cannot contract away the implied covenant of good faith and fair dealing, specifically where they may have eliminated other fiduciary duties. *Lonergran v. EPE Holdings, 5 A.3d 1008, 1017 (Del. Ch. 2010)*. Lower courts have found that if a traditional fiduciary duty is not explicitly limited or eliminated, it is applied as a default corporate rule. *See, e.g., Gerber v. Enterprise Products Holdings*, 2012 WL 34442, at *3-4; *Bay Center Apartments Owner v. Emery Bay PKI*, 2009 WL l124451, at *2. Further, in contractual relationships, an implied covenant of good faith exists where a court must ask if "it is clear from what was expressly agreed upon that" the parties "would have agreed" to act as they ultimately did. *Gerber v. Enterprise Products Holdings*, 67 A.3d 400, 418 (Del. 2013).

a. **Sierra Resources GP did not explicitly shield themselves from the duty of care, but only from monetary damages.**

General partners can be held liable for breaching their fiduciary

duties if they control corporate assets of a limited partner. 62 A.3d at 671. Whether default fiduciary duties apply in situations where ambiguity exists within the contract has not yet been resolved by this Court. *See Gatz Props. v. Auriga Capital Corp.*, 59 A.3d 1206, 1208 (Del. 2012). However, the narrower ruling in *USA Cafes* has been consistently followed: that in cases where "control over the partnership's property" has been used to "advantage the corporate director," fiduciary duties still apple. 2009 WL 1124451 at *10.

Sierra Resources GP indisputably controls their limited partner Sierra Resources LP, specifically in their decision to hire counsel to negotiate the terms of their note and its conditions. Though the general partner claims not to have affirmatively requested the dead hand provision in the terms, its failure to perform adequate care creates liability for the extreme limitations placed on the plaintiff's shareholder franchise. The Court must not waiver from the consistent ruling in *USA Cafes* where the general partner has used their investment in a limited partner to their own exclusive benefit at great cost to the reasonable expectations of the plaintiff.

b. The limited partnership arrangement does not waive the duty of loyalty.

The limited partnership agreement did not explicitly preempt duty of loyalty claims. Since there is not "clear contractual language" that excludes the duty of loyalty, courts may still "continue to apply them." *Werner, M.D. v. Miller Technology Management, L.P.,* 831 A.2d 318, 333 (Del. Ch. 2003). Thus, Sierra Resources GP must still comply with Delaware's duty of oversight in loyally ensuring that they are

entirely fair with respect to decisions that will financially affect their limited partners. *Weinberg v. UOP, Inc.,* 457 A.2d 701, 707 (Del. 1983). Under Delaware law, directors of the general partnership must ensure a fair process and a fair price when negotiating terms of a note that will affect the limited partner. *Id.*

The note's dead hand provision does not meet entire fairness standard. In their negotiations, the process was not fair to the limited partner, which used the same counsel as their general partner had to rely on their guidance for approval of the terms. The counsel did not determine that any controversial or potentially novel terms were in the agreement, even when the general partner asked. Further, the price was not fair for this particular term. Morgan Stanley only stated that the interest rate on the note could be as high as 50 basis points higher, but this is not necessarily true. Protecting against a small increase in interest rate by effectively abridging the limited partner's shareholder franchise was not entirely fair – even under these market conditions.

c. An implied covenant of good faith exists to govern the contractual relationship even without fiduciary duties.

An implied covenant of good faith in contracting requires "loyalty to the scope, purpose, and terms of the parties' contract." 67 A.3d at 419. In *Gerber*, this Court held that a plaintiff must show that a defendant general partner "acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that [the limited partner] reasonably expected." *Id* at 421. There, a limited partner was essentially forced to sell of an asset for 9% of the price it was

purchased for 2 years earlier. The general partner frustrated the reasonable expectations of the limited partner and breached the implied covenant of good faith in the contract.

Sierra Resources GP also violated the implied covenant of good faith, even if fiduciary duties were waived in their contract. On behalf of their limited partner, Sierra Resources GP negotiated an indenture agreement to their own benefit while significantly limiting shareholder franchise through a dead hand provision. Within the original limited partnership agreement, the plaintiff would not have agreed to limit their ability to change corporate control in this manner. Like *Gerber*, the general partner acted in a way that abused its discretion, relying solely on the word of counsel that they hired to represent both parties in a negotiation made to their own benefit.

CONCLUSION

The Court of Chancery correctly ruled correctly in favor of the Appellee because Sierra Resources GP inappropriately included a dead-hand proxy put within the terms of a note for their limited partner. Furthermore, the general partner did not successfully contract out of all of their fiduciary duties owed to a limited partner under Delaware Law. Default fiduciary duties still do apply, and Sierra Resources GP has breached those duties with respect to the Appellee. This Court therefore must affirm the Court of Chancery's judgment in favor of the Appellee.

Respectfully Submitted,

Team R

Counsel for Appellee