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,

Appellants,

and

SIERRA PROPERTIES LP,

Nominal Appellant.

v.

NORTH CAROLINA POLICE RETIREMENT FUND, individually and derivatively on behalf of SIERRA PROPERTIES LP,

Appellee,

C.A. No. 12871-CS

Appellants' Opening Brief

Team S
Attorneys for Appellants

February 3, 2017

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NATURE OF PROCEEDINGS

Appellee commenced this action on January 20, 2016, derivatively in the right of Sierra LP, claiming that approval of the Indenture containing Section 11.01 violated Appellants' fiduciary duties to Appellee and Sierra LP. Appellants moved pursuant to Court of Chancery Rule 12(b)(6) to dismiss the complaint for failure to state a claim upon which relief can be granted. In support of this motion, Appellants presented matters not included in the complaint. As a result, the Court determined to treat Appellants' motion to dismiss as a motion for summary judgment. Pursuant to Court of Chancery Rule 12(b), Appellee was afforded an opportunity for discovery limited to the additional matters presented by the Appellants. Appellee and Appellants agree there are no genuine issues of material fact. Based on this agreement, Appellee has presented a cross-motion for summary judgment in its favor.

Appellants maintain that the undisputed facts require judgment in their favor; Appellee asserts that the same facts should result in a judgment in its favor. The Court of Chancery granted Appellee's motion for summary judgment. Therefore, Appellants appealed to the Supreme Court of the State of Delaware from the order of the Court of Chancery.

SUMMARY OF ARGUMENT

I. Defendants did not violate their fiduciary duty by including Section 11.01, a "dead-hand proxy put," in the Indenture. First, defendants are entitled to the benefit of the business judgment rule in evaluating their adoption of provisions such as Section 11.01 when they are not adopted as defenses to takeovers. Section 11.01 was not adopted

to protect against any stated proxy solicitation threat but instead for a legitimate business purpose, to ease interaction with creditors. The Court of Chancery erred in dismissing the business judgment rule; it also erred in relying only on its dicta to evaluate whether defendants had breached their duties of care and loyalty to shareholders. Defendants did not breach their duties of care and loyalty since they consulted multiple in-house and outside counsel and iterated several drafts of the Indenture. Additionally, since this provision was adopted on a clear day, rather than in the shadow of a proxy contest, none of the Court's recent precedents apply regarding "dead-hand" proxy puts. It is essential that this Court reverse the lower court's erroneous decision to prevent trampling on directors' rights to self-govern and make legitimate business decisions.

II. Sierra Resources and the Individual Defendants (collectively "Sierra Resources") do not owe fiduciary duties to Appellee. First, imposing such duties on Sierra Resources is contrary to the limited purpose underlying *USACafes* doctrine. This purpose is based on (1) a breach of trust directly involving Appellee's property and (2) the knowledge and intentionality of the corporate general partner. Because (1) Appellee's property was not directly involved in the inclusion of Section 11.01 and (2) Sierra Resources lacked the requisite knowledge and intentionality, Sierra Resources should not be subject to liability for violation of fiduciary duties to Appellee. Second, even if Sierra Resources did owe fiduciary duties to Appellee under *USACafes*, the *USACafes* doctrine should be abandoned due to its violation of legal separateness principles and capacity to create conflicting fiduciary

duties for general corporate partners. Third, rejecting *USACafes* doctrine would re-align corporate default rules with the bedrock principle of legal separateness and avoid redundancy with aiding and abetting doctrine.

STATEMENT OF FACTS

At the height of the housing crisis, Sierra Resources, Inc. ("Sierra Resources"), a publicly-traded Delaware company, entered into negotiations with the North Carolina Retirement Fund ("Appellee") to form a joint venture that would redevelop and invest in sustainable commercial buildings. Mem. Op. at 4. To do so, Sierra Resources formed an investment vehicle, Sierra Energy Partners LP ("Sierra LP"), funded 80 percent by Appellee and 20 percent by the sole general partner of Sierra LP, Sierra GP LLC ("Sierra GP"). Mem. Op. at 4.

After several years, Sierra Resources realized Sierra LP was underleveraged and moved to raise debt to increase the entity's profitability. Mem. Op. at 5. Sierra GP discussed the indenture with Appellee and, with Appellee's blessing, received financing that would eventually lead to a $160 million public offering in 2% notes (the "Notes") due 2028. Mem. Op. at 5. A trust indenture (the "Indenture") associated with this transaction was produced after several rounds of drafting. Mem. Op. at 5.

Sierra Resources consulted both outside and in-house counsel during the drafting process of the Indenture and produced three preliminary drafts before finalizing the agreement. Included in the provision was an oft-used provision, a "dead-hand" proxy put that would protect

creditors' ability to request repayment of the debt in the event of an unexpected proxy contest or solicitation that would shake up the board. Mem. Op. at 6.

Two years after signing the Indenture, High Street Partners, LP ("High Street") filed a Schedule 13D with the SEC to indicate that it had acquired 6.3% of Sierra Resources' outstanding shares and to state its intention to propose a new governing strategy to Sierra Resources. Mem. Op. at 6. High Street stated it would consider a potential solicitation of proxies if the strategy was not adopted; however, it has taken virtually no steps to embark down this path. Mem. Op. at 6-7.

Appellee filed derivative suit in January 2016, asserting that the earlier approval of the Indenture violated defendants' fiduciary duties despite High Street's lack of action. The court below granted summary judgment in favor of the Appellee.

ARGUMENT

I. DEFENDANTS DID NOT VIOLATE THEIR FIDUCIARY DUTY WITH THE INCLUSION OF THE "DEAD-HAND" PROXY PUT PROVISION IN SECTION 11.01 OF THE INDENTURE

A. QUESTION PRESENTED

Should an entity's Board of Directors that includes a "dead-hand" proxy put feature in an Indenture be considered in violation of its fiduciary duty to its shareholders by including the provision?

B. SCOPE OF REVIEW

A trial court's decision on a grant of summary judgment is subject to a de novo standard of review on appeal. *See Leonard Loventhal Account v. Hilton Hotels Corp., C.A.* No. 17803, 2000 WL 1528909, at *4. ("[T]he doctrine of stare decisis is applicable to a decision of a court higher

in rank, or of the same rank, but not to a decision of a court lower in rank than the court in which the decision is cited as precedent.") (internal quotations omitted).

C. MERITS OF THE ARGUMENT

1. Defendants are entitled to the benefit of the business judgment rule in evaluating their adoption of the proxy put provision

This court has historically protected the rights of directors to manage their organization's affairs. When directors are disinterested, their decisions are protected by the business judgment rule. *Aronson v. Lewis*, 488 A.2d 858, 872 (Del. 1985). When the business judgment rule is invoked, directors' decisions will be upheld absent an abuse of discretion. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). If the business judgment rule is applied, the presumption is that "directors 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." *Aronson* at 812. When the business judgment rule applies, the board's decisions "will not be disturbed if they can be attributed to any rational business purpose." *eBay Domestic Holdings, Inc., v.* Newmark, 16 A.3d 1 (Del. 2010). The business judgment rule is available even when organizations face a takeover threat, but organizations must first clear the hurdle this court prescribed in *Unocal* because of the "omnipresent specter" that the board may be acting in its own interests. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). Under *Unocal*, the business judgment rule may be applied in takeover situations after directors have established "reasonable grounds" for believing a danger to corporate effectiveness existed. *Id.* at 955.

i. *Unocal* does not apply because the provision was not adopted in response to a threat

This court and the Court of Chancery have held that when measures such as the provision in question are adopted *in response to* a specific threat, *Unocal* is the appropriate standard of review. *See, e.g.*, *Yucaipa American Alliance Fund v. Riggio*, 1 A.3d 310 (2010). However, the Court of Chancery held in *Doskocil Cos. v. Wilson Foods*, 1988 WL 85491 * 670, 679, that because defendant directors neither asked for nor wanted the put provision at issue in the case, the *Unocal* standard was inapplicable and business judgment should instead be used to evaluate defendant's adoption of the provision. In *Unocal*, the court articulated that the analysis comes into play only when a board is "address[ing]…a pending takeover bid." *Unocal* at 954.

However, *Unocal* is inapplicable in the present case because the "dead-hand" provision was not adopted as a defensive measure. The Section 11.01 provision was included in the Indenture from its inception; it "remained unchanged from the time of its initial preparation by underwriter's counsel until execution of the final form of the indenture." Mem. Op. at 5. Indeed, when the parties entered into the Indenture, there was not "any indication" that an election contest may take place. Mem. Op. at 6. Defendants also never "suggested or encouraged the inclusion of" the provision. Mem. Op. at 6.

ii. There is a legitimate business purpose for the provision: to keep and maintain relationships with creditors

There is a legitimate business purpose for the provision: it protects creditors' interest in knowing their borrowers and building

confidence in their investment. Proxy puts of this kind are not unilaterally adopted by the board of directors; they are negotiated with a third party to incentivize those parties into investment. *See* T. Brad Davey & Christopher N. Kelly, Dead Hand Proxy 'Puts' Face Continued Scrutiny From Plaintiffs' Bar, BLOOMBERG LAW (June 12, 2015). The Court of Chancery's jurisprudence on this issue is limited, but it held in *Pontiac Gen. Employees Ret. Sys. V. Ballantine, C.A. No. 9780-VCL*, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) ("*Healthways*") that the commonly held "know-your-borrower" rationale is most applicable to private companies, where the universe of borrowers is small and creditors have a genuine interest in maintaining that relationship. While Sierra Resources is publicly traded, Sierra LP is not; this "private-company" rationale applies here.

The business judgment rule should apply because the inclusion of the "dead-hand" feature was not in response to a threat and because defendants had a legitimate business interest in including the provision, namely to satisfy its creditors and raise capital. However, even if this Court believes that *Unocal* should apply, the decision to include the provision survives. When a board fails to apply a *Unocal* analysis, "where such an approach is required," the court "will [not] automatically invalidate the corporate transaction" but will switch to an entire fairness analysis. *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 257, 271 (Del. Ch. 1989). If the entire fairness standard is triggered, the board must demonstrate the decision or transaction was inherently fair to the shareholders by proving fair price and fair dealing. *See. e.g., Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). Fair

dealing implicates when the transaction was timed, how it was initiated, structured and negotiated; fair dealing implicates the economic and financial considerations of the transaction, including all relevant factors. *Id*. at 711. More, all aspects of the issue "must be examined as a whole." *Id.*

Defendants offer an affidavit from underwriter Morgan Stanley demonstrating that without Section 11.01, creditors would have driven the interest rate on the notes significantly higher. Mem. Op. at 9. The Court of Chancery erroneously held that this affidavit could not satisfy the entire fairness burden because defendants failed to offer "any proof" that the inclusion of Section 11.01 avoided any specific additional interest cost. But taking the situation "as a whole," as mandated by this court in *Weinberger*, defendants' decision was clearly meant not to entrench the board but instead to facilitate an easy transaction with creditors. Defendants had no affirmative knowledge of future proxy contests; defendants assented to the provision only because of creditor demand. More, the transaction itself was undertaken to "improve Sierra LP's profitability," a decision surely in the interest of the shareholders. Mem. Op. at 5. Therefore, even under the more stringent entire fairness standard, defendants' inclusion of Section 11.01 in the indenture survives.

2. Defendants did not violate the duty of care or the duty of loyalty and thus did not breach their fiduciary duty to shareholders

To rebut the business judgment rule, plaintiffs must prove that the defendant board of directors breached the duty of loyalty, of good

faith or of due care. *See, e.g.*, *McMullin v. Beran*, 765 A.2d 910 (Del. 2000). To demonstrate a breach of the duty of care, plaintiffs must prove that directors acted with gross negligence. *Aronson*, 473 A.2d at 812. More specifically, this court has held that the proper standard for determining gross negligence is to consider whether the director acted in an "informed and deliberate manner," *Smith v. Van Gorkom*, 488 A.2d at 873. Directors are "fully protected" in relying on reports made by officers. 8 *Del. C. § 141(e)*, *see also Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). "Report" has also been liberally construed in the courts. *Cheff v. Mathes*, 199 A.2d 548, 556 (Del. 1964). The duty of loyalty mandates that the corporation's best interests and the interests of the corporation's shareholders should take precedence over any director interest. *See 8 Del. C. § 141(a)*, *see also Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984).

i. **The Court of Chancery erred in determining it was unnecessary under the circumstances to determine whether defendants breached a duty of care or loyalty**

The Court of Chancery held that it is "unnecessary under the circumstances" for the Court to consider whether defendants actually breached their duties of care or loyalty. The Court relied on its analysis in *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 307-308 (Del. Ch. 2009) to make this point. The Court's analysis centered on a single sentence from dicta in *Amylin*, highlighting the *Amylin* court's point that even "customary" provisions should be highlighted to the board. However, the Court of Chancery's use of dicta erroneously missed the point of the *Amylin* holding: that the

board in question in *Amylin* did *not* breach its duty of care precisely because it received advice from "highly qualified counsel." *Id.* at 318-319. This court affirmed the Court of Chancery's holding in *Amylin II*, further holding that the board did not breach its duty of care in authorizing a similar indenture because the plaintiff did not show that approving the proxy put "would involve any reasonably foreseeable material risk to the corporation or its stockholders." *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 1173, n.2 (Del. 2009). While the *Amylin* court certainly cautioned counsel to highlight potentially problematic provisions, it in no way made the significant leap to hold that if counsel *did not* do so, it would indicate a breach of duty on the part of the board.

ii. **Defendants did not violate the duty of care or loyalty because they repeatedly consulted outside counsel regarding the proxy put and did not affirmatively seek to include the alleged offending provision in the Indenture**

The Court's holding that defendants automatically breached their duty of care because counsel did not effectively highlight Section 11.01 cuts against years of jurisprudence in the court regarding the duty of care: that it simply requires directors make their best efforts to be informed.

The Court of Chancery holds here that it "cannot accept that the blame for the failure to heed this admonition in this case must lay solely at the doorstep of outside counsel." Mem. Op. at 10. However, the jurisdiction's own law cuts against that premise. According to DGCL § 141(e), a director can rely on reports by officers, committees, etc., if he reasonably believes the subject of the report is within that

person's professional competence. DGCL §102(b)(7) further holds that directors are exculpated from damages for breach of the duty of care unless they act in violation of the duty of loyalty, with intentional misconduct or with a knowing violation of the law.

In the present case, defendants made four overtures to fully inform themselves of the provisions of the indenture. First, they consulted outside counsel at Morgan Stanley to prepare the document. Mem. Op. at 5. Next, they consulted inside counsel subsequently to the original drafting of the document. Mem. Op. at 5. Next, they solicited approval from the finance committee of the board. Mem. Op. at 5. Finally, they asked outside counsel if there were any novel terms that required attention from the committee or the board, and were told there were none. Mem. Op. at 6. In the backdrop of these negotiations was nothing but securing creditor protection: again, defendants had no knowledge of any potential proxy contests or solicitations and did not consider these threats when negotiating the indenture.

Defendants' repeated attempts to consult counsel regarding these provisions constitute duties above and beyond those that would satisfy their burden of care; under the law, their reliance on a single counsel's opinion would have sufficed. Defendants did not violate the duty of care or loyalty because they made significant efforts to inform themselves of contract terms and to spot problems in drafts of the Indenture.

iii. **Recent case law does not implicate the facts here because this provision was adopted on a "clear day"**

The Court of Chancery has admittedly engaged with "dead-hand" proxy provisions in recent jurisprudence, particularly the 2015 *Healthways*

decision. In *Healthways*, the court declined to dismiss plaintiff's allegations that the board of directors breached its fiduciary duties when it included a dead-hand provision in its credit agreement. *See generally Healthways*. However, the "dead-hand" provision in *Healthways* was adopted just days after a stockholder vote expressing discouragement in the company. *Healthways* at 28. It was adopted on a "cloudy day" – in the shadow of a proxy contest. Indeed, Vice Chancellor Laster, who decided *Healthways*, clarified his ruling in the settlement hearing after the case: calling the ruling "frequently misunderstood," he stated that it "can't be stressed enough" that his holding only applied to provisions "adopted in the shadow of a proxy contest," – not "any change-in-control provision." *Healthways*, Settlement Hearing No. 9789-VCL (slip op., May 8, 2015).

The provision adopted by Sierra was clearly enacted on "a clear day." Directors could not foresee a proxy contest on the horizon; they had no reason to believe that a solicitation of this type was imminent. Mem. Op. at 6. For this reason, the *Healthways* ruling – and any others like it – are clearly not applicable. This court has never come close to an out-and-out ban on dead-hand proxy puts; to hold organizations accountable to a clearly unsettled legal principle would be to subject them to unfair liability.

II. SIERRA RESOURCES AND THE INDIVIDUAL DEFENDANTS DO NOT OWE FIDUCIARY DUTIES TO THE APPELLEE

A. QUESTIONS PRESENTED

First, whether Sierra Resources and the members of its Board of Directors (collectively "Sierra Resources") should be held liable under the doctrine in *In re USACafes, L.P Litig.*, 600 A.2d 43, 48-49 (Del. Ch.

1991). Second, whether *USACafes* doctrine should be abandoned due to its violation of legal separateness principles and capacity to create conflicting fiduciary duties for general corporate partners. Third, whether abandonment would create beneficial consequences for corporate law more generally.

B. SCOPE OF REVIEW

As discussed in the previous section, the standard of review for cases before the Delaware Supreme Court is *de novo*.

A. MERITS OF ARGUMENT

1. Imposing fiduciary duties on Sierra Resources violates the limiting language in *USACafes* rationale

In *In re USACafes, L.P Litig.*, 600 A.2d 43, 48-49 (Del. Ch. 1991), the Chancery Court held that the directors of a corporate general partner may, under certain circumstances, owe a fiduciary duty directly to the LP and the limited partners of the LP. This is because "one who controls the 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 its beneficial owner." *USACafes*, 531 A.2d at 48. The Chancery Court did not derive this standard from corporate law precedent. Instead, it reached the principle through an analogy to trust law. In trust law, it is accepted that any officer who "knowingly causes the corporation to commit a breach of trust causing loss. . .is personally liable to the beneficiary of the trust." *Id.* at 48.

Both the rationale for the holding in *USACafes* and the equitable principle on which the holding is based contain limiting language circumscribing the conditions under which directors of a corporate

general partner owe fiduciary duties. *See, e.g.*, *Wallace ex rel. Cencom Cable Income Partners II, Inc., L.P. v. Wood*, 752 A.2d 1175, 1180 (Del. Ch. 1999). First, the controlling party must breach the beneficial owner's trust by using the beneficial owner's property to hurt the owner and advantage itself. Second, it must cause this breach of trust knowingly and intentionally.

Therefore, *USACafes* doctrine does not extend fiduciary obligations to all general corporate partners. Rather, these obligations extend only to general corporate partners who fulfill these requirements. The following analysis will show that neither requirement is fulfilled in this case. Hence, Sierra Resources does not owe fiduciary duties to the Appellee.

First, Sierra Resources did not breach Appellee's trust by using Appellee's investment in Sierra LP to induce the inclusion of Section 11.01 in the Indenture. Applied to this case, the Appellee's investment in Sierra LP is the "property." Mem. Op. at 11. The dead hand proxy put in Section 11.01 of the Indenture is the item that the Appellee alleges benefits Sierra Resources to the detriment of the Appellee's interests. In *USACafes*, the "property" involved the assets of USACafes LP. *Id.* at 46. The defendants used these assets to their benefit by offering them to a buyer at a very low price in return for side payments. *Id.* The plaintiffs did not receive any portion of the side payments and were cheated out of a fair price on the asset sale. *Id.* Therefore, the assets were a key element of the scheme that benefitted the defendants and disadvantaged the plaintiffs. By contrast, in this case, the Appellee's property played no direct role in the inclusion of Section 11.01. As the

prior section explained, the inclusion of the dead hand proxy put benefited all parties to the transaction by improving Sierra LP's profitability and easing transactions with creditors. However, even if the inclusion disadvantaged the Appellee, Sierra Resources did not use the Appellee's property to achieve the inclusion. Therefore, it falls outside the scope of the "breach of trust" underlying *USACafes* doctrine.

Second, Sierra Resources did not intentionally or knowingly include the dead hand proxy put in Section 11.01. In *USACafes*, the intentionality and knowledge requirements were clearly met. The directors of the general partner purposefully orchestrated a scheme to authorize the sale of the LP's assets for less than the price that a fair negotiation would have yielded in exchange for side payments. *Id.* at 46. Moreover, the amended complaint claimed that the defendants did not engage sufficiently in the process of shopping the LP's assets and did not implement any post-agreement market check procedure. *Id*.

Similarly, these requirements were met in much of *USACafes*' progeny. In a similar case, for example, plaintiffs alleged that the officers of the general partner circumvented a provision in the Partnership Agreement by using Partnership funds to wrongfully establish business entities and acquire additional leverage. *Wallace*, 752 A.2d at 1179. Then, for "purely self-interested reasons adverse to the interest of the partnership," the officers used this leverage to make "exorbitantly over-priced" acquisitions and generate fees for themselves. *Id.*

By contrast, the affirmative actions indicating intentionality in *USACafes* and *Wallace* are absent in this case. There is no evidence that

any representative of Sierra Resources intended for Section 11.01 to be in the Indenture. Discovery did not reveal any action to suggest or encourage the inclusion of Section 11.01. Mem. Op. at 5. Provisions like Section 11.01 are often included as boilerplate language in financial agreements. Although counsel for Sierra LP and Sierra Resources reviewed the draft of the Indenture and provided multiple comments and suggested edits, Section 11.01 remained unchanged from the time of its initial preparation until execution of the final form of the indenture. *Id.* Indeed, the fact that counsel for Sierra LP was included throughout the editing process further distinguishes this case from *USACafes* and its progeny. In *USACafes*, the corporate general counsel exercised its control unilaterally, without the implied or express agreement of other parties to the LP. In this case, Sierra LP implicitly agreed to the inclusion of Section 11.01 by declining to raise objections despite being included as a party to the editing process.

Moreover, there is no evidence that those negotiating on behalf of Sierra Resources knew about the inclusion of Section 11.01 or its potential effects on the Appellee. These individuals did not communicate with the underwriter about Section 11.01. *Id.* Moreover, when they asked the company's outside counsel if there were any novel terms that required attention from finance committee or the board, outside counsel responded in the negative. Mem. Op. at 6. Finally, when Sierra LP entered into the Indenture, there was no warning that any entity would plan a proxy contest or be interested in acquiring a significant equity portion of Sierra Resources. Therefore, there is no reason to believe that Sierra Resources had specific knowledge that the Section 11.01 would trigger

the Noteholders' put rights. *Id.* The Appellee may nonetheless urge the Court to impute knowledge to Sierra Resources because shareholder activism was "well known" in the real estate industry around the time of Indenture negotiations. *Id.* As evidence, the Chancery Court cites the "widely reported" effort by Corvex Management to change the business strategy and, if necessary, the composition of the trustees of CommonWealth REIT. *Id.*

However, just because shareholder activism impacted CommonWealth REIT does not imply that Sierra Resources was "aware of a high probability" of shareholder activism at Sierra Resources. Del. Code Ann. tit. 11, § 255 (West). CommonWealth was unlike Sierra Resources (and most other real estate investment trusts) in a number of ways that encouraged shareholder unrest and made CommonWeath especially vulnerable to takeover attempts.

For example, the outside management company that ran CommonWealth was paid based on the size of CommonWealth's assets rather than how the investments performed. Gretchen Morgenson, *Management, to the Barricades!*, N.Y. TIMES, May 4, 2014, http://www.nytimes.com/2013/05/05 /business-commonwealth-trustees-guarding-the-status-quo.html. Therefore, CommonWealth issued 88 million new shares from 2010 to 2013 to acquire new properties. This severely diluted existing shareholders' stake by increasing the number of investors that share in the company's payouts. *Id.* Moreover, the incentive structure at CommonWealth encouraged the management company to pay a hefty fee for its acquisitions. *Id.* As a result of CommonWealth's selling equity and buying assets without regard to investment performance, CommonWealth's shares

fell 7 percent and it cut its dividends in 2012. *Id.* However, as shareholders suffered, the founder of CommonWealth and his son – both of whom run the outside management company and dominated CommonWealth's board – earned $118 million in advisory fees during the years leading up to the 2013 takeover. *Id.*

Sierra Resources has no such incentive structure in place, and there is no indication that it diluted shareholders' stake or cut its dividends. Since the management structure of Sierra Resources does not encourage shareholder unrest in the way that CommonWealth's did, there is no reason that the CommonWealth takeover would have alerted the Sierra Resources to a similar threat.

To be held liable under the rationale behind *USACafes*, Sierra Resources would need to have (1) directly used the Appellee's property in a scheme to benefit itself to the detriment of Appellee; and (2) intended for Section 11.01 to be in the Indenture, known that Section 11.01 was in the Indenture, and been aware that the dead hand proxy put provision had a substantial probability of triggering Noteholders' rights. Because none of these conditions are fulfilled, Sierra Resources should not be held liable under *USACafes*.

2. ***USACafes* doctrine should be rejected because it contravenes the principle of legal separateness and creates internal conflicts for general corporate partners**

Even if Sierra Resources were liable under *USACafes* doctrine, that doctrine should be rejected because it (1) contravenes the principles of legal separateness and (2) creates internal conflicts for the equitable principle of fiduciary duty. *See, e.g.*, Moshen Manesh, *The*

Case Against Fiduciary Entity Veil Piercing, 72 BUSINESS LAWYER (2017). The following analysis will elaborate on each of these points in turn.

i. ***USACafes* doctrine violates the principle of legal separateness**

An essential principle of entity law is that of legal separateness: a business entity (in this case Sierra GP) is a legal person, distinct from the entity's managers (Sierra Resources). *See, e.g.*, 18 AM. JUR. 2D *CORPORATIONS* § 2 (2016); REV. UNIF. LTD. LIAB. CO. ACT § 104(A) (UNIF. LAW COMM'N 2006); *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 667 (Del. Ch. 2012). According to now-Chief Justice Strine, "Delaware public policy does not lightly disregard the separate legal existence of corporations...The reason for this is that the use of corporations is seen as wealth-creating for society as it allows investors to cabin their risk and therefore encourages investment of capital in new enterprises." A correlative principle of legal separateness is the principle of limited liability, which means that the owners and managers of a business are not liable for the obligations of the entity. *Feeley*, 62 A.3d at 667.

USACafes violates the principles of legal separateness and limited liability. *See, e.g.*, *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, C.A.* No. 3658-VCS, 2009 WL 1124451, at *9 n. 44 (Del. Ch. Apr. 20, 2009) (Strine, V.C.) ("[T]he imposition of fiduciary duties on individuals who work for [an entity] fiduciary charged with managing an alternative entity . . .disregards [entity] formalities in a manner unusual for Delaware law . . . ."). Applied to this case, instead of treating Sierra GP as a separate legal person independent from its

owners, *USACafes* opens the door to imputing Sierra GP's fiduciary duties to Sierra Resources under the circumstances outlined above.

It is true that *USACafes* is not the only instance in which a doctrine rooted in equity has displaced fundamental principles of legal separateness and limited liability. *See Feeley*, 62 A.3d at 667; Manesh, *supra*, at 75. One example analogous to the holding in *USACafes* is the doctrine of corporate veil piercing in favor of a third-party creditor of a limited liability entity. *See, e.g.*, *Irwin & Leighton, Inc. v. W.M. Anderson Co.*, 532 A.2d 983, 987 (Del. Ch. 1987).

Veil piercing is an exceptional, uncommon remedy. *See, e.g.*, Christine Hurt et al., BROMBERG & RIBSTEIN ON PARTNERSHIP § 13.07[A] (2014-4 Supp.)("Veil piercing . . . is extremely rare, and courts are loath to find that the factors enabling veil piercing exist."). Therefore, courts require plaintiffs to meet the high threshold of "fraud or similar injustice" to invoke this standard; "[m]ere domination and control" over an entity is not enough to justify piercing. *Outokumpu Eng'g Enters., Inc. v. Kvarerner EnviroPower, Inc.*, 685 A.2d 724, 729 (Del. 1996). Indeed, absent this high standard, veil piercing would become routine, standard practice. Manesh, *supra*, at 75.

By contrast, *USACafes* allows a much lower threshold: liability is rooted in the general corporate partner's degree of control over the sub-entity rather than the magnitude of the injustice the general corporate partner allegedly caused. Although the *USACafes* standard is limited by the requirements discussed above, it does not encompass the "grave injustice" threshold necessary to protect bedrock principles of legal separateness and limited liability. Under the more stringent veil

piercing standard, even if Sierra Resources knowingly or intentionally used Section 11.01 to benefit itself to the detriment of the Appellee, this would nonetheless be insufficient to guarantee liability. Indeed, under the "grave injustice" standard, Sierra Resources would clearly not be held liable. The company's due diligence efforts during Indenture negotiations and the absence of evidence of shareholder unrest each weigh heavily against any fraudulent deception on the part of Sierra Resources.

Because *USACafes* doctrine violates the principle of legal separateness without incorporating a sufficiently high threshold for liability, it should be rejected in favor of the traditional veil piercing doctrine.

ii. ***USACafes* doctrine creates conflicting fiduciary duties for general corporate partners**

USACafes doctrine would impose on Sierra Resources a potentially conflicting set of fiduciary duties owed to the shareholders of Sierra Resources as well as the limited partners of Sierra LP. Chief Justice Strine recognized this problem in his earliest critiques of *USACafes*, noting the "awkward position" the doctrine creates for general corporate partners. *Gelfman v. Weeden Investors, L.P.*, 792 A.2d 977, 992 n. 24 (Del. Ch. 2001); *see also Bay Ctr. Apartments*, 2009 WL 1124451 at *9 n. 44 ("[T]he imposition of fiduciary duties on individuals who work for [an entity] fiduciary charged with managing an alternative entity raises some difficult policy issues . . . .").

The notion that corporate directors should serve multiple masters has been disparaged for inviting litigation, exacerbating the risk of personal liability, and facilitating managerial accountability to any one constituency. *See* Stephen M. Bainbridge, *In Defense of the*

Shareholder Wealth Maximization Norm: A Reply to Professor Green, 50 WASH & LEE L. REV. 1423, 1437 (1993); Frank H. Easterbrook & Daniel R. Fishel, *The Economic Structure of Corporate Law* 38 (1991). However, under *USACafes* doctrine, this is exactly what they are expected to do. Manesh, *supra*, at 81.

3. Abandoning *USACafes* doctrine would have minimal consequences for alternative entity law and is made redundant by aiding and abetting doctrine

In practice, *USACafes* merely establishes a default rule: general corporate partners will have fiduciary duties under the circumstances described above unless these duties are waived or modified by the terms of the agreement governing the beneficiary entity. DEL. CODE ANN. tit. 6, § 17-1101(d) (allowing for "other person's duties" to be expanded, restricted or eliminated by provisions in the LP agreement); *see also* Manesh, *supra*, at 90. Because parties already posses the power to reject *USACafes* through contract, abandoning *USACafes* would merely flip the default rule to align with fundamental principles of corporate law.

The Appellee may argue that a change in the default rule be unfair to parties that relied on it by leaving their LP agreement silent about the duties of the controlling fiduciary entity. However, since the doctrine of *USACafes* has been the subject of judicial criticisms (such as those by Chief Justice Strine quoted above) and has never been expressly embraced by the Delaware Supreme Court, it is unlikely that parties have intentionally relied on the default rule as a substitution for express contract rules. Manesh, *supra*, at 91. Rather, contractual silence is likely because the parties were unaware of the default rule or did not consider the matter *ex ante*. *Id.*

Second, all claims that the Appellee currently make against the controller of a fiduciary duty under *USACafes* could be recast as aiding and abetting a breach of fiduciary duty claim. *Id.* at 96. The claim would be that the controller knowingly participated in – and thus aided and abetted – the fiduciary entity's breach of duty. *Id.* Indeed, to the extent the Delaware Supreme Court has found liability in cases analogous to *USACafes*, it has found directors liable under aiding and abetting doctrine. *See, e.g.*, *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 795 A.2d 1, 29-30 (Del. Ch. 2001) (Strine, V.C.).

The Appellee may argue that, if claims based on aiding and abetting liability enable similar claims as presently permitted by *USACafes*, judicial abandonment of *USACafes* should also prompt reconsideration of aiding and abetting doctrine. However, even though aiding and abetting doctrine might enable similar claims, this doctrine sometimes produces a different result than *USACafes* doctrine. In civil litigation contexts, courts have held that individuals charged with managing an entity cannot be held separately liable for decisions taken on behalf of the entity. *Buttonwood Tree Value Partners*, 2014 WL 3954987, at *5. Similarly, in the context of civil conspiracy claims, courts have held that a corporate officer cannot be liable for "conspiring" with a corporation for which she serves as an officer. *See, e.g.*, *In re Am. Int'l Grp., Inc., Consol. Derivative Litig.*, 976 A.2d. 872, 889-90 (Del. Ch. 2009). Taken together, these precedents indicate judicial respect for the concept of legal separateness because they disallow claims against entity's managers and agents for actions taken on behalf of the entity. By enacting this higher

standard, aiding and abetting doctrine aligns more closely with fundamental precepts of corporate law than does *USACafes* doctrine.

Second, regardless of how the courts choose to address the continued viability of aiding and abetting doctrine, the problems for *USACafes* are the same. Manesh, *supra*, at 91. The abolition of *USACafes* doctrine would simply mean the courts would need to eventually address the issues raised by aiding and abetting liability rather than neglect them. *Id.*

CONCLUSION

For the foregoing reasons, this Court should reverse the Court of Chancery's order and grant Defendants' motions to dismiss.

Respectfully submitted,

Team S
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