

**A PYRRHIC VICTORY FOR PREFERRED STOCKHOLDERS:  
Places Premium on Proper Certificate Drafting  
Fiduciary Duty to Preferred Holders Deemed “Superfluous”**

A “win” for the preferred stockholders in *Fletcher International Ltd. v. Ion Geophysical Corporation*<sup>1</sup> may be a pyrrhic victory for preferred stockholders in general.<sup>2</sup> In *Fletcher*, the Delaware Chancery Court continued the trend of recent cases that limited preferred stockholders to their contract rights and cast doubt on the scope of the fiduciary duty owed to preferred stockholders.

The issue in *Fletcher* was whether the issuance of convertible notes by a subsidiary of Ion Geophysical without the consent of the preferred stockholders violated the certificate of designations for the preferred stock and was a breach of the fiduciary duty owed to the preferred stockholders. The Court found in favor of the preferred stockholders, holding that the issuance was a violation of the certificate of designations. However, what makes the case disturbing for preferred stockholders in general is that the Court went on to hold that, because the case was decided based on the contract rights contained in the certificate of designations, any breach of duty claim was “superfluous.”<sup>3</sup>

The *Fletcher* case can be seen as part of a trend that was accelerated by the *Trados*<sup>4</sup> case of almost a year ago and continued in *LC Capital Master Fund*.<sup>5</sup> These three cases leave preferred stock investors with a number of stark principles:

- **Contract Rights.** Courts will enforce the express contract rights of preferred stockholders, but those contract rights do not give rise to any fiduciary duties in favor of preferred stockholders.<sup>6</sup>

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<sup>1</sup> CA No. 5109-VCP (D.Ch. May 28, 2010).

<sup>2</sup> The concept of a pyrrhic victory, i.e., one so costly that it may practically constitute a defeat, is named after King Pyrrhus of Epirus, whose army suffered irreplaceable casualties in defeating the Romans at Heraclea in 280 BC and Asculum in 279 BC and who is reputed to have said, “If we are victorious in one more battle with the Romans, we shall be utterly ruined.” See [http://en.wikipedia.org/wiki/Pyrrhic\\_victory](http://en.wikipedia.org/wiki/Pyrrhic_victory).

<sup>3</sup> *Fletcher* at 22.

<sup>4</sup> *In re: Trados Incorporated Shareholder Litigation*, 2009 WL 2225958 (Del. Ch. July 24, 2009).

<sup>5</sup> *LC Capital Master Fund, Ltd. v. James*, CA No. 5214-VCS (Del. Ch. March 8, 2010).

<sup>6</sup> *Fletcher* at 21 (“rights arising from documents governing a preferred class of stock . . . that are enjoyed solely by that preferred class, do not give rise to fiduciary duties because such rights are purely contractual in nature” (internal citations omitted)).

- ***Situations Where There is No Fiduciary Duty to Preferred Stockholders. Where it matters most:***
  - ***Matters Covered by the Certificate of Designations.*** A fiduciary duty is deemed “superfluous” for matters addressed by the certificate of designations.<sup>7</sup>
  - ***Conflict between Preferred Stock and Common Stock.*** In the event of a conflict between the preferred stock and the common stock, a board of directors’ duty is to the common stock. “[I]t will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock . . . to the interests of the [preferred stock].”<sup>8</sup>
- ***Situations Where Directors “MAY” Owe a Fiduciary Duty to Preferred Stockholders. Where it may not matter:***
  - ***Gap Filling (but not in conflict with the common stock).*** The Court in *Fletcher* recognized that the board of directors “may” owe fiduciary duties to preferred stockholders in cases where the certificate of designations does not address an issue which “leaves the holder of preferred stock in an exposed and vulnerable position vis-à-vis the board of directors.”<sup>9</sup> However, it is hard to see where such a situation is not also a conflict between the preferred stock and the common stock. In those conflict situations, it is clear that the board’s primary duty is to the common stockholders. That was precisely the case in *LC Capital Master Fund*, where the certificate of designations was silent as to the treatment of the preferred stock in the merger, and the Court found that the board’s duty was to the common holders.<sup>10</sup>
  - ***Where the Preferred Stock and the Common Stock Share the Same Right.*** In those situations, the directors “owe the preferred shareholders the same fiduciary duties they owe the common shareholder with respect to those rights.”<sup>11</sup> In those circumstances, however, it is not clear that the ‘duplicate’ fiduciary duty adds any value to the preferred stockholders, as it can be presumed that the common stockholders will enforce the fiduciary duty owed to them.

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<sup>7</sup> *Fletcher* at 22.

<sup>8</sup> *LC Capital* citing *Trados*.

<sup>9</sup> *Fletcher* at 20 (internal quotations omitted).

<sup>10</sup> See Willkie Farr & Gallagher LLP Client Memorandum “Warning to Preferred Stock Investors from the Delaware Courts,” May 3, 2010.

<sup>11</sup> *Fletcher* at 21.

The practical lessons for preferred stock investors are clear: **make sure that the certificate of designations is clear as to the rights of the preferred stock, because the preferred stockholders cannot rely on fiduciary duty to protect them.** We at Willkie are ready to assist you in drafting documents for your new investments and to review your existing investments.

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