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Trial Court Decision Provides Guidance for Investors and Lenders Regarding Significant Shareholder's Fiduciary Duties to Other Shareholders Under Delaware Law

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To Our Clients and Friends:

After three and one-half years of litigation and an 18-day bench trial in San Francisco Superior Court, defendants Baker Capital, a private equity firm that invests in growth companies, and its related investment funds ("Baker"), achieved a complete victory against plaintiffs, former controlling stockholders, officers and directors of an internet retailer named Wine.com, Inc. ("Wine.com," or the "Company"). Plaintiffs had brought separate direct and derivative actions against Baker in cases entitled *Flying Disc Investments LP, et al. v. Baker Communications Fund II, L.P., et al* and *Flying Disc Investments LP, et al. v. Wine.com, et al.* (Case Nos. CGC-05447293 and 05447294) (Oct. 15, 2009). The trial court's 67-page Statement of Decision provides important guidance to investors and lenders--particularly those who may be subject to litigation in California, or who invest in or lend to Delaware incorporated companies--regarding the application of Delaware case law on the fiduciary duties owed by a large stockholder to other stockholders. Among other things, the decision affirmed the right of a significant stockholder in a Delaware corporation who does not control the corporation to make decisions in its own interest--even if those decisions conflict with the interests of other investors. The decision also affirmed that merely because a large stockholder holds certain special or preferred rights, such as the right to approve or reject major corporate transactions, holding such rights does *not* turn the significant stockholder into a "controlling stockholder" (with the attendant duties owed by a controlling stockholder) under Delaware law.

I. Background

The dispute in these actions arose from a relationship that began when Wine.com found itself--not for the first time--on the brink of insolvency in 2004. Plaintiffs, the controlling stockholders, officers and directors of Wine.com at the time, sought out defendants, a group of private equity investors, to invest in the Company in an "F" round of financing. Defendants agreed, and purchased the majority of a new "F" series of preferred shares of the Company. As a result of

this purchase, defendants owned approximately 35% of Wine.com's shares, received two seats (out of seven) on the company's board, and had the right to approve (or veto) major corporate transactions, such as a sale, merger or financing. After completion of the F financing, the lead plaintiff (who was also the Chairman of the Board of Directors of the Company) retained approximately 35% of Wine.com's shares and held the same approval or veto rights as Baker. The following year, plaintiffs began negotiating with a third party--Liberty Media ("Liberty")--for a possible merger. In the course of protracted negotiations with Liberty, and after Baker had previously agreed to sign an initial letter of interest from Liberty, Liberty demanded that Baker, as a stockholder, sign a second letter of intent containing a "no-shop" clause that would serve to limit Wine.com's ability to seek other potential acquirers or financing. After deciding that this was a poor negotiating tactic, and wanting to preserve the Company's leverage, Baker declined to sign the LOI. Although Liberty and Wine.com continued to negotiate towards a merger, Liberty's Board of Directors ultimately voted against pursuing such a transaction. Later that year, with Wine.com running out of money, and after no other third parties would commit to acquiring or financing the Company, Baker led another financing round in Wine.com--the "G" round. Baker's offer in the G round included a rights offering provision that allowed any existing stockholder to participate *pro rata* in the financing. The Wine.com board approved this transaction, although plaintiffs later claimed that they had done so under "duress." The G financing round gave Baker majority control of the Company for the first time, the right to appoint two of three board members, and the right to appoint a new CEO who would hold the third seat on the board.

After the G financing round, plaintiffs filed their complaints against the Baker defendants (which initially included the Baker funds that had made the investment in Wine.com, their general partner, and a Baker Capital investment professional who was also the founder of Baker Capital). The complaints alleged that the Baker defendants had been controlling stockholders of Wine.com from their initial investment, and had breached fiduciary duties to both plaintiffs and the Company by allegedly preventing the sale of the Company to Liberty and then increasing their ownership in Wine.com through the G financing. Plaintiffs also claimed that defendants breached an implied covenant of good faith and fair dealing, were unjustly enriched by their conduct, and that defendants made fraudulent representations and failed to disclose material facts in conjunction with their original investment in Wine.com. Plaintiffs sought damages of \$66 million, plus unspecified punitive damages and attorney fees.

Following trial, the court ruled in defendants' favor on all claims in both the direct and the derivative actions.

II. Analysis

The court's decision included several important rulings regarding the standards for fiduciary duty owed by an investor under Delaware law. The court applied Delaware, not California, law on the breach of fiduciary duty claims because Wine.com is incorporated in Delaware. The decision is significant because there are few California cases interpreting and demarcating a private equity investor's fiduciary duty under Delaware law.

First, the court affirmed that a stockholder does not owe fiduciary duties unless the stockholder "owns a majority interest in or exercises control over the business affairs of the corporation." *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1113-14 (Del. 1994). Because defendants were not a majority owner and did not "control" the company, Baker's refusal to sign the Liberty LOI did not give rise to, let alone violate, a fiduciary duty.

Second, the court held that Baker did not "control" Wine.com even though it was a significant minority stockholder with special rights, such as the right to approve or reject major corporate transactions. The court found it persuasive that Baker did not have a majority of the Board seats and did not engage in day-to-day management of the Company. Most significantly, the fact that Baker had "blocking rights" to prevent a sale or merger of the Company did not constitute control over the Company. In short, under Delaware law, a stockholder's leverage over a specific transaction does not equal control. *See Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 130-31 (Del. Ch. 2007);

Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) ("nothing precludes . . . a stockholder from acting in its own self-interest").

Third, the court held that even if Baker *had* been found to control the Company, its actions vis-à-vis the LOI would be subject to the business judgment rule, which creates a rebuttable presumption that the fiduciary acted properly, and the burden is on plaintiffs to overcome this presumption by demonstrating that the decision in question cannot "be attributed to any rational business purpose." *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). Thus, even if Baker had owed a fiduciary duty, its decision not to sign the Liberty LOI could not be deemed irrational because Baker adduced significant evidence that the decision not to sign the LOI was made both as a negotiating tactic and also to afford the Company opportunities to pursue other financing or merger options.

Fourth, the court found that even if plaintiffs had established Baker's control over the Company *after* refusing to sign the LOI, Baker's actions in providing further financing (and thereby increasing their ownership stake in the Company) did not violate either the business judgment rule or the more exacting "entire fairness" test that applies when a fiduciary stands on both sides of a transaction. *The determinative factor in the entire fairness analysis was that Baker had structured the financing so that every shareholder of Wine.com could, if it wanted to, purchase its pro rata share of the offering.* In other words, the transaction was not for the "exclusive benefit" of defendants, which under Delaware law is strong evidence of fairness. See *Feldman v. Cutaia*, 956 A.2d 644, 658-59 (Del. Ch. 2007) (*aff'd* 951 A.2d 757 (Del. 2008)). Indeed, the court also found that even in a third financing that was completed after the lawsuits had been initiated (an "A-1" round)--even though Baker indisputably controlled the Company at that point--the fact that the third financing was also open to all stockholders on a *pro rata* basis was sufficient to satisfy the "entire fairness" test.

III. Conclusion

The decision in the *Flying Disc* cases shows a California trial court affirming certain bedrock principles of Delaware law regarding the fiduciary duties owed by a significant stockholder. The *Flying Disc* decision makes clear that significant, non-controlling stockholders may act in their own interest even if their actions conflict with other stockholders' interests. The decision also confirms that under Delaware law, a stockholder's leverage over a specific transaction does not equal control. Moreover, if there is any question as to whether a significant stockholder "controls" a corporation or partnership, an investor or stockholder may minimize litigation exposure by taking steps to ensure that a transaction is both procedurally and substantively fair; for example, by allowing all stockholders the opportunity to participate in the transaction on a *pro rata* basis.

Mitchell A. Karlan and Michael A. Sitzman led the Gibson Dunn litigation and trial team on behalf of Baker.

Gibson Dunn lawyers are available to assist in addressing any questions you may have about these developments. Please contact the Gibson Dunn lawyer with whom you work, any member of the firm's Real Estate or Private Equity Practice Groups, or the following lawyers:

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