



IN THE COURT OF CHANCERY FOR THE STATE OF DELAWARE

MCG CAPITAL CORPORATION, for itself  
and in the right and for the benefit of Jenzabar,  
Inc.,

Plaintiff,

v.

Case No. 4521-CC

ROBERT A. MAGINN, JR., LING CHAI,  
JAMISON BARR, JOSEPH SAN MIGUEL,  
DANIEL QUINN MILLS, JENZABAR, INC.,

Defendants,

and

JENZABAR, INC.,

Nominal Defendant.

**PLAINTIFF'S SUPPLEMENTAL BRIEF  
CONCERNING PREFERRED STOCKHOLDER DERIVATIVE STANDING**

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Date: January 11, 2010

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## PRELIMINARY STATEMENT

By letter dated December 17, 2009, the Court asked the parties to file supplemental briefing answering the following question:

Under Delaware law, can a preferred shareholder bring a derivative action on the company's behalf and, if so, are there any limitations on the type of preferred shareholder who may bring a derivative action?

This brief is plaintiff's answer to the foregoing question. In sum, it has long been established under Delaware law that a holder of preferred shares has the same right as other stockholders to bring a derivative action. A preferred stockholder's standing to bring a derivative suit is grounded in the fact that preferred stock enjoys the same rights and powers as common stock, except to the extent modified by the certificate of incorporation. No such certificate of incorporation modification applies here, and therefore plaintiff MCG Capital Corporation ("MCG") possesses standing to bring the derivative claims asserted.

## ARGUMENT

### **I. UNDER DELAWARE LAW, A PREFERRED STOCKHOLDER CAN BRING A DERIVATIVE ACTION ON THE COMPANY'S BEHALF**

As a threshold matter, MCG is unaware of any case (Delaware or otherwise) holding that a preferred stockholder lacks standing to bring a derivative action. Furthermore, we are aware of no case holding a common stockholder could bring a derivative suit, but a preferred stockholder could not bring the same suit.

In fact, preferred stockholders have long been permitted to bring derivative lawsuits on behalf of the corporations whose equity they own. *Ashwander v. TVA*, 297 U.S. 288, 321 (U.S. 1936) (holding that preferred stockholders possessed standing to bring derivative suits; rejecting argument that preferred shares "are virtually in the position of bondholders" and holding that preferred stockholders "are not creditors but shareholders" to whom directors owe fiduciary

duties regardless of the fact that “their shares have certain preferences”); *Rosan v. Chicago Milwaukee Corp.*, 1990 Del. Ch. LEXIS 19, at \*23 (Del. Ch. Feb. 6, 1990) (denying motion to dismiss preferred stockholder’s derivative claim for waste); *Lewis v. Great W. United Corp.*, 1978 Del. Ch. LEXIS 723, at \*1 (Del. Ch. Mar. 28, 1978) (awarding fees for class and derivative action filed on behalf of the preferred holders in which Court preliminarily enjoined self dealing merger by controlling common stockholder).<sup>1</sup>

In *Rosan*, for example, this Court not only permitted a preferred stockholder to proceed with derivative claims, but affirmatively held that the preferred stockholder was able to serve as an adequate representative of the corporation’s interests. *Rosan*, 1990 Del. Ch. LEXIS 19, at \*23. As is shown below, preferred stockholders have standing to bring a derivative action under

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<sup>1</sup> See also *In re Eugenia Vi Venture Holdings, Ltd.*, 649 F. Supp. 2d 105, 124 (S.D.N.Y. 2008) (holding that preferred stockholders possessed standing to bring derivative claims for breach of fiduciary duty); *In re Ionosphere Clubs*, 156 B.R. 414, 438 (S.D.N.Y. 1993) (holding preferred stockholders have standing to bring a derivative claim such as breach of fiduciary duty); *Osann v. Jones*, 209 A.D. 9, 10 (N.Y. App. Div. 1924) (holding preferred stockholder has standing to bring derivative claims to set aside a fraudulent transaction) (citing *Tooker v. Sugar Refining Co.*, 80 A. 10 (N.J. Ch. 1912) and *Scully v. Automobile Finance Co.*, 101 A. 908 (Del. Ch. 1917) (same)). Cf. *Klebanow v. New York Produce Exchange*, 344 F.2d 294, 297 (2d Cir. 1965) (finding that limited partners had standing to bring derivative claims on the grounds that preferred stockholders had standing). Even those Delaware cases rejecting derivative claims by preferred stockholders on the merits have not denied the preferred stockholders’ standing. See, e.g., *Thornton v. Bernard Techs., Inc.*, 2009 Del. Ch. LEXIS 29, 15-16 (Del. Ch. Feb. 20, 2009) (dismissing derivative claims for self dealing by preferred stockholders on the grounds that bankruptcy court approval had not been obtained); *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 128 (Del. Ch. 2007) (rejecting preferred stockholders’ derivative disclosure claims on the merits rather than on standing, which the Court considered and implicitly approved earlier in the case); *Winston v. Mandor*, 710 A.2d 835, 845 (Del. Ch. 1997) (dismissing preferred stockholder’s derivative claim for self-dealing because the claim was not pled with specificity, while granting leave to freely amend); *Weinberger v. Lorenzo*, 1990 Del. Ch. LEXIS 169, at \*10 (Del. Ch. Oct. 11, 1990) (dismissing preferred stockholder’s derivative claims for breach of fiduciary duty on the grounds that corporation in bankruptcy was an indispensable party).

Delaware case law and that right is not restricted by the Delaware General Corporate Law (the “DGCL”) or the Court of Chancery Rules (the “Rules).

**A. Preferred Stockholders Possess the Same Standing As Common Stockholders To Bring Derivative Actions**

**1. Preferred Stockholders Share The Remedies of Common Stockholders Unless Modified by the Certificate of Incorporation**

“At common law and in the absence of an agreement to the contrary all shares of stock are equal.” *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593-594 (Del. Ch. 1986) (holding that preferred stockholders are owed fiduciary duties). *See also* David A. Drexler et al., 1-15 *Delaware Corporation Law And Practice* § 15.13 (1998) (“Preferred stockholders are, after all, stockholders to whom is owed the same loyalty and care owed to common stockholders.”). Because preferred shares are simply common stock whose rights have been modified by contract pursuant to 8 *Del. C.* § 151, “[e]xcept insofar as their contract may otherwise provide, preferred stockholders undoubtedly have all the remedies that common stockholders have against the corporation, its directors and other officers, and majority stockholders.” 18 *C.J.S. Corporations* § 209 (2007); Jennifer L. Berger, et. al., *Fletcher Cyclopedia of the Law of Private Corporations* §5973 (2004 Rev. Ed. 2004) (“A holder of preferred shares has the same right as other shareholders to bring a derivative action.”)

The “preferences and limitations associated with preferred stock exist only by virtue of an express provision (contractual in nature) creating such rights or limitations. But absent negotiated provision conferring rights on preference stock, it does not follow that no right exists. . . . Rather, in such circumstances, the preferred stock has the same . . . rights as common stock[.]” *Jedwab*, 509 A.2d at 593-594. *See also* *Matulich v. Aegis Communs. Essar Invs., Ltd.*,

942 A.2d 596, 600 (Del. 2008) (“If a certificate of designation is silent as to voting rights, preferred stockholders have the same statutory rights as common stockholders”).

Thus, where they seek to vindicate rights held by the corporation (such as a remedy for unfair self-interested and/or wasteful use of corporate funds), preferred stockholders possess the same rights, remedies, and standing to bring derivative claims as common stockholders.

## **2. As Equity Holders, Preferred Stockholders Share the Right to Bring Derivative Actions**

Derivative actions’ origins lie in the law of trusts:

‘Although the corporation holds all the title, legal or equitable, to the corporate property, and is the *immediate cestui que* trust under the directors with respect to such property, and is theoretically the only proper party to sue for wrongful dealings with that property, yet courts of equity recognize the truth that the stockholders are ultimately the only beneficiaries; that their rights are really, though indirectly, protected by remedies given to the corporation; and that the final object of suits by the corporation is to maintain the interests of the stockholders.’

*Schoon v. Smith*, 953 A.2d 196, 201 n.10 (Del. 2008) (quoting 4 *Pomeroy’s Equity Jurisprudence* § 1095, at 277 (5th ed. 1941)) (emphasis in original) (noting that “the equitable standing of a stockholder to bring a derivative action was judicially created”). Therefore, “[t]o prevent ‘a failure of justice,’ courts of equity granted equitable standing to stockholders to sue on behalf of the corporation . . .” in order to protect the underlying equity interests of the stockholders. *Id.*

Preferred stockholders, like common stockholders, possess an equity rather than a debt interest in the corporation and thus, like common stockholders are the ultimate beneficiaries of actions brought on behalf of the corporation. *Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broad. Corp.*, 906 A.2d 218, 224 (Del. Ch. 2006) (“the cases presented to the court appear almost unanimous in support of the conclusion that the preferred shares in this case are

not debt, but equity”).<sup>2</sup> Although preferred stockholders possess liquidation or dividend preferences over common stockholders, nonetheless “the holder of preferred stock is in the exposed and vulnerable position vis a vis the board of directors that all stockholders occupy.” *HB Korenvaes Inv., L.P. v. Marriott Corp.*, 1993 Del. Ch. LEXIS 90, at \*15 (Del. Ch. June 9, 1993) (recognizing that “directors may owe duties of loyalty and care to preferred stock.”). Preferred stockholders remain dependant upon director discretion to issue dividends and upon director skill to ensure that there is sufficient capital available to satisfy the liquidation preference should the company be liquidated. *Id.* at \*15. As a result, preferred stockholders are owed fiduciary duties by the corporation’s directors. *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1062 (Del. Ch. 1987) (fiduciary duties to preferred stockholders would likely be violated by coercive self-tender offer). Preferred stockholders, like common stockholders are given the ability to step in to protect the interests of the corporation should the directors breach their fiduciary duties to do so. *See Ashwander*, 297 U.S. at 321 (rejecting notion that preferred shares “are virtually in the position of bondholders”).

### **3. The Case Law Denying Standing to Sue Derivatively to Creditors and Warrant Holders Does Not Apply to Preferred Stockholders.**

Preferred stockholders’ standing to bring derivative claims is not subject to the limitations placed on creditors’ standing. The court in *Gheewalla* limited creditor standing to the zone of insolvency because “[w]hile shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law,

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<sup>2</sup> The Supreme Court in *N. American Catholic Educational Programming Foundation, Inc. v. Gheewalla* extended standing to bring derivative claims to creditors in the zone of insolvency because at that point the creditors have an economic interest in the corporate entity. 930 A.2d 92 (Del. 2007); *Schoon*, 953 A.2d at 208 n. 46.

general commercial law and other sources of creditor rights.” 930 A.2d at 99. In *Harbinger*, this Court held that preferred stockholders were not entitled to the remedies available to creditors. 906 A.2d at 225 (holding that preferred stockholders had access to the same remedies as common stockholders, not creditors). “The holder of preferred stock is not a creditor of the corporation. Such a holder has no legal right to annual payments of interest, as long term creditors will have, and most importantly has no maturity date with its prospect of capital repayment or remedies for default.” *HB Korenvaes*, 1993 Del. Ch. LEXIS 90, at \*15. “Even where preferred shares in some way straddle the line between debt and equity, the cases which have grappled with that question in the context of bankruptcy law have held, almost universally, that those shares are forms of equity.” *Harbinger*, 906 A.2d at 225. *See also Ashwander*, 297 U.S. at 321 (preferred stockholders “are not creditors but shareholders”); *Treves v. Menzies*, 37 Del. Ch. 330, 335 (Del. Ch. 1958) (“These [preferred] stockholder plaintiffs are not creditors and dividends are not due them until such dividends are declared. Plaintiffs look upon themselves as money lenders rather than investors, a concept at odds with modern corporate law principles”); *In re Federated Dep’t Stores, Inc.*, 1991 Bankr. LEXIS 67, at \*7-9 (Bankr. S.D. Ohio Jan. 23, 1991) (preferred stock’s mandatory redemption rights remained contingent on the financial health of the company); *In re Revco D.S., Inc.*, 118 B.R. 468, 474-75 (Bankr. N.D. Ohio 1990) (mandatory redemption provision did not confer creditor status on a preferred stockholder).

Unless the certificate of incorporation provides otherwise, preferred stockholders also have the right to vote, whereas creditors have no voting rights unless expressly provided. *Compare* 8 *Del. C.* § 212 (providing voting rights to preferred stockholders by default) *with* 8 *Del. C.* § 221 (denying voting rights to creditors by default). Similarly, preferred stockholders, but not creditors, may bring books and records requests by statute, 8 *Del. C.* § 220, and are

entitled to appraisal rights unless those rights are modified by contract. 8 *Del. C.* § 262(b). Therefore, while preferred stockholders stand ahead of the common stockholders in dividend and liquidation preference, the law groups them solidly alongside the common stockholders when assigning the ability to enforce the corporation's rights and control the corporate machinery.

And, while Courts have held that warrant holders lack standing to sue as a result of 8 *Del. C.* § 327 and Court of Chancery Rule 23.1 because they do not possess a current equity interest in the corporation, that limitation does not apply to preferred stockholders. *In re New Valley Corp. Derivative Litig.*, 2004 Del. Ch. LEXIS 107, at \*18 (Del. Ch. June 28, 2004) (noting that warrant holders may not sue under Rule 23.1). As explained above, preferred stockholders, like common stockholders, have a present equity interest in the corporation, the value of which is dependant upon the directors' faithful service to the corporation. *Harbinger*, 906 A.2d at 225. Therefore, preferred stockholders, as a specie of stockholder, are not subject to the standing limitations placed on creditors or warrant holders.

**B. Neither the DGCL, Nor the Rules Restrict Preferred Stockholders' Standing to Sue Derivatively**

Although both the DGCL and the Rules explicitly address standing to bring derivative actions, neither restricts preferred stockholders' standing to do so. *See* 8 *Del. C.* § 327; Ct. Ch. Rule 23.1. Additionally, while the DGCL empowers corporations to create classes of preferred stock, it does not provide that preferred stock will differ from common stock other than as explicitly modified. 8 *Del. C.* § 151.

The limitations on standing in derivative actions have nothing to do with the class of stock owned. Instead, section 327 of the DGCL limits stockholder standing to sue to holders that retain ownership of their shares from the time of the wrong through the entire lawsuit:

In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a

stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.

Rule 23.1 contains an analogous limitation.<sup>3</sup> This timing requirement not only denies standing to stockholders who bought into the lawsuit, but it establishes that convertible instruments cannot form the basis of standing to sue. *New Valley Corp.*, 2004 Del. Ch. LEXIS 107, at \*18 (quoting *Helvering v. S.W. Consol. Corp.*, 315 U.S. 194, 200-01 (1942)) (holding that warrants did not provide standing to sue derivatively because “the ‘convertibility’ feature of warrants ‘does not impart an equity element until conversion occurs.’”). Thus, the DGCL and Rules already place what the drafters consider the necessary limitations on derivative standing, which do not include any unique limitation because of the preferred status of a class of stock.

Similarly, section 151 of the DGCL grants corporations the ability to adjust the preferences of each class of stock without in anyway infringing preferred stockholders’ standing to bring derivative suits. 8 *Del. C.* § 151(a) (corporations may issue stock for “any or all of which classes . . . [that] may have such . . . such designations, preferences . . . as shall be stated and expressed in the certificate of incorporation or of any amendment thereto[.]”) Nothing in section 151 empowers a corporation to strip a class of stock of derivative standing. Moreover, section 151 does not suggest that awarding a preference can somehow implicitly strip stockholders of their pre-existing ability to enforce the fiduciary duties owed them. *See Shintom*

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<sup>3</sup> Ct. Ch. Rule 23.1 states in pertinent part:

In a derivative action brought by 1 or more shareholders . . . to enforce a right of a corporation . . ., the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder . . . at the time of the transaction of which the plaintiff complains or that the plaintiff's share . . . thereafter devolved on the plaintiff by operation of law.

*Co. v. Audiovox Corp.*, 888 A.2d 225, 228 (Del. 2005) (labeling stock “‘preferred’ conveys no special meaning in the abstract. The preferences must be specifically defined in the governing instruments.”). Therefore, although the DGCL permits the creation of preferred stock, it does not suggest that unintended consequences, such as the elimination of derivative standing, will follow from such a designation.

## **II. ALL PREFERRED STOCKHOLDERS POSSESS STANDING TO BRING DERIVATIVE ACTIONS**

As detailed above, preferred stockholders, just like common stockholders, possess standing to bring derivative suits. *See* 18 C.J.S. *Corporations* § 209 (2007) (preferred stockholder remedies identical to common stockholder remedies). Preferred stockholders’ rights differ from those of common stockholders only “by virtue of an express provision . . . creating such rights or limitations.” *Jedwab*, 509 A.2d at 593. Although section 151 permits a corporation to modify preferences and voting, it does not provide that standing to bring derivative claims is in any way affected by any such modifications. Therefore, regardless of the other modifications imposed by the certificate of incorporation, preferred stock retains the right, identical to that of the common stock, to bring derivative claims. *Matulich*, 942 A.2d at 601 (Del. 2008) (“Any . . . limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated [and these] . . . limitations will not be presumed or implied.”<sup>4</sup>

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<sup>4</sup> Even were derivative standing modifiable under section 151(a), no such modification was included in the Jenzabar certificate of incorporation. To be effective a modification must be clear and unambiguous because “ambiguity in these matters ought to be construed against the issuer who . . . had it within its power clearly to establish the result for which it here contends.” *In re Appraisal of Ford Holdings*, 698 A.2d 973, 978 (Del. Ch. 1997) (finding that only clear drafting is able to limit rights of preferred stockholders).

**CONCLUSION**

For all of the forgoing reasons plaintiff MCG respectfully contends that preferred stockholders possess standing to bring derivative claims under all circumstances in which a common stockholder would have standing to bring such claims.

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Date: January 11, 2009