IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

MCG CAPITAL CORPORATION, for itself and in the right and for the benefit of Jenzabar, Inc.,	)	
Plaintiff,	)	
v.	)	
ROBERT A. MAGINN, JR., LING CHAI, JAMISON BARR, JOSEPH SAN MIGUEL, DANIEL QUINN MILLS, and JENZABAR, INC.,	)	C.A. No. 4521-CC
Defendants,	)	
and	)	
JENZABAR, INC.,	)	
Nominal Defendant.	)	

SUPPLEMENTAL BRIEF IN SUPPORT OF MOTION TO DISMISS OF DEFENDANTS JENZABAR, INC., JAMISON BARR, JOSEPH SAN MIGUEL, AND DANIEL QUINN MILLS

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INTRODUCTION

In their Opening and Reply Briefs in support of their Motion to Dismiss, Defendants demonstrated that MCG Capital Corporation's Complaint is fundamentally deficient in numerous respects: among other things, MCG[1] failed to make the required pre-suit demand, is incapable of representing Jenzabar's interests and is impermissibly asserting direct contract rights in the guise of fiduciary duty claims. *See* OB at 13-25, 37-45, RB 6-14. In its December 17, 2009 request for supplemental briefing, this Court asked the parties to brief a related question: whether, under Delaware law, a preferred shareholder may bring a derivative action on a company's behalf and, if so, whether there are any limitations on the type of preferred shareholder who may bring a derivative action. *See* Trans. ID No. 28554055.

As set forth in greater detail below, this Court has held that preferred stockholders are ***not*** owed fiduciary duties, and thus cannot assert direct fiduciary duty claims, unless the preferred stockholders share a right equally with the common stockholders. *Rosan v. Chi. Milwaukee Corp.*, 1990 WL 13482, at *6-7 (Del. Ch. Feb. 6, 1990) (citing *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986)). The Delaware Supreme Court recently applied this very same reasoning when it considered the scope and nature of fiduciary duties owed to creditors of a corporation, holding that a creditor can assert such claims only derivatively and only if the corporation is insolvent, in which case the creditors "take the place of the shareholders as the residual beneficiaries of any increase in value." *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007). Applying the principles set forth in *Rosan* and *Gheewalla*, a preferred stockholder should be permitted to maintain a

[1] Unless otherwise specified, defined terms shall have the same meaning as used in the Opening Brief in Support of Motion to Dismiss of Defendants Jenzabar, Inc., Jamison Barr, Joseph San Miguel, and Daniel Quinn Mills ("OB," Trans. ID No. 25946487) and the Reply Brief in Support of Motion to Dismiss of Defendants Jenzabar, Inc., Jamison Barr, Joseph San Miguel, and Daniel Quinn Mills ("RB," Trans. ID No. 26909209).

derivative action if, and only if, the preferred stockholder shares with the common stockholders a proportional economic interest in the appreciation or depreciation of the value of the corporation or where the preferred stockholders "take the place of" the common stockholders as the "residual beneficiaries of any increase in value." Where, by contrast, the economic interest of the preferred stockholder is limited to a contractual preference amount, and that preference is not alleged to be impaired, the preferred stockholder cannot maintain a derivative action.

Under the terms of Jenzabar's preferred stock, MCG's economic interest as a preferred stockholder is limited to the contractual preference value of the preferred stock, and there is no allegation that the preference has been impaired such that MCG has "taken the place of" the common stockholders as the "residual beneficiar[y] of any increase in value." MCG has no interest in the residual value of Jenzabar: when Jenzabar acted to repurchase the Senior Preferred Stock held by MCG in April 2009, Jenzabar irrevocably deposited the full preference value for the Senior Preferred Stock with a paying agent where it remains for MCG to claim at any time. Accordingly, MCG should not be permitted to maintain a derivative action.

ARGUMENT

I. A CORPORATE STAKEHOLDER CAN MAINTAIN A DERIVATIVE CLAIM ONLY WHERE THE STAKEHOLDER WILL BE THE ULTIMATE BENEFICIARY OF ANY INCREASE IN THE CORPORATION'S VALUE

Delaware law provides for a separation of ownership and control. *Gheewalla*, 930 A.2d at 101. Directors are obligated to manage the corporation for the benefit of its stockholder owners, *id.*, and in so doing, directors owe fiduciary duties to the corporate entity and, in some circumstances, to the stockholders directly. The derivative action was developed in equity to allow stockholders—as the ultimate economic beneficiaries of the corporate enterprise—to enforce corporate rights where their directors are unwilling or unable to do so. *See Agostino v. Hicks*, 845 A.2d 1110, 1116 (Del. Ch. 2004). Where a plaintiff alleges that directors have breached the fiduciary duties owed to the corporate enterprise and seeks a remedy for the alleged harm that would benefit the corporation, the plaintiff's claim is a derivative claim. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1035 (Del. 2004). "Where all of a corporation's stockholders are harmed and would recover *pro rata* in proportion with their ownership of the corporation's stock solely because they are stockholders, then the claim is derivative in nature." *Feldman v. Cutaia*, 951 A.2d 727, 733 (Del. 2008); *see also Kramer v. W. Pac. Indus., Inc.*, 546 A.2d 348, 353 (Del. 1988) ("where a plaintiff shareholder claims that the value of his stock will deteriorate and the value of his proportionate share of the stock will be decreased as a result of alleged director mismanagement, his cause of action is derivative in nature").

In a derivative action, therefore, the corporation—not the stockholder plaintiff—is the real party in interest, and the plaintiff's interest exists solely because of its pro rata economic interest as a stockholder. *See In re MAXXAM, Inc. Federated Dev. S'holders Litig.*, 698 A.2d 949, 956 (Del. Ch. 1996). Because the claim being enforced in a derivative action belongs to the corporation, not the stockholders, Delaware law places limitations even upon common stockholders seeking to pursue derivative litigation. *See, e.g.*, 8 *Del. C.* § 327; Ct. Ch. R. 23.1; *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999) ("Since a stockholder suing derivatively is bringing a corporate claim, not a personal one, the stockholder must maintain his or her status as a stockholder in order to continue the litigation."). These limitations on derivative standing are intended to protect the corporation's interest in its asset (the corporate claim) and to insure that the party bringing the derivative action is properly incentivized to pursue derivative litigation only when it is in the corporation's interests to do so.

In *Gheewalla*, the Delaware Supreme Court discussed at some length the boundaries of standing to pursue derivative claims. 930 A.2d at 92. There, the specific question before the Supreme Court was whether and when a corporate creditor could pursue fiduciary duty claims. *Id.* at 94. The Court concluded that such claims could be maintained by creditors only derivatively, and only where the corporation is insolvent. *Id.*

The Supreme Court's analysis in *Gheewalla* is instructive here. The Court's analysis began from first principles, reiterating that a derivative action seeks to enforce duties owed by the directors to the corporation as an entity, and that equity permits those rights to be asserted only by a corporate stakeholder who will be the ultimate or residual beneficiary of any increase in the corporation's value. *Id.* at 101-02. The Court stated:

> It is well settled that directors owe fiduciary duties to the corporation. When a corporation is solvent, those duties may be enforced by its shareholders, *who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value*. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.
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> Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. *The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value."* Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

Id. (footnotes and citations omitted and emphasis added). Thus, under *Gheewalla*, it is only when a creditor of a corporation has "taken the place" of the common stockholders as the residual beneficiary of any increase in the value of the corporate assets, *i.e.*, when the corporation is insolvent, that the creditor is allowed to bring derivative claims.

II. PREFERRED STOCKHOLDERS CANNOT PURSUE DERIVATIVE CLAIMS UNLESS THE PREFERRED STOCK SHARES WITH THE COMMON STOCK AN ECONOMIC INTEREST IN THE APPRECIATION OR DEPRECIATION IN THE VALUE OF THE CORPORATION

This Court's analysis in *Rosan* and the Supreme Court's analysis in *Gheewalla* all but answers the question posed by the Court here: a preferred stockholder has standing to pursue derivative litigation if, and only if, the terms of the preferred stock are such that the preferred stock shares proportionally with the common equity an economic interest in the appreciation or depreciation in corporate value that could result from the derivative litigation or the preferred stockholders have "taken the place" of the common stockholders as the "residual beneficiaries of any increase in value"—circumstances, as discussed below, that are not present in this case.

For any specific preferred stock, the terms set forth in the certificate of designations define the rights of the preferred stockholder. *See Matter of Appraisal of Ford Holdings, Inc. Preferred Stock*, 698 A.2d 973, 977 (Del. Ch. 1997) ("To the extent [preferred stock] possesses any special rights or powers and to the extent it is restricted or limited in any way, the relation between the holder of the preferred and the corporation is contractual."); *see also Matulich v. Aegis Commc'ns Group, Inc.*, 942 A.2d 596, 601 (Del. 2008) ("Any rights, preferences and limitations of preferred stock . . . must be expressly and clearly stated . . . . [and] will not be presumed or implied."). Thus, whether a preferred stockholder has the type of economic interest that is required to support derivative standing will depend entirely upon the terms of the certificate of designations that creates the preferred stock.

In general, there are two scenarios in which a preferred stockholder might be deemed to have such an economic interest. The first circumstance is where the terms of the preferred stock provide that the preferred stock will participate proportionally with the common stock in dividends or upon liquidation once the preference amount has been satisfied (*i.e.*, "participating preferred"). *Cf.* Lawrence E. Mitchell, *The Puzzling Paradox of Preferred Stock (And Why We Should Care About It)*, 51 Bus. Law. 443, 477 n.28 (1996) ("One also assumes that in the case of participating preferred stock, that is preferred stock which shares residual wealth in some proportion with the common, ordinary fiduciary rights clearly apply to protect this residual."). As discussed in Defendants' Opening and Reply Briefs, *see* OB at 37-40 and RB at 20-22, this Court has recognized that a preferred stockholder is owed *direct* fiduciary duties only where the right asserted is one that is shared equally by preferred and common stockholders. *Rosan*, 1990 WL 13482 at *6-7; *see also Harbinger Capital Pr's Master Fund I, Ltd. v. Granite Broad. Corp.*, 906 A.2d 218, 224 (Del. Ch. 2006) ("[P]referred stockholders have access to fiduciary duty claims where the rights of common stock and preferred stock intersect."). From this, it follows that a preferred stockholder's equitable right to pursue *derivative* fiduciary duty claims should also be limited, in the first instance, to cases in which the preferred stock shares with the common stock an economic interest in any increase (or decrease) in the value of the company.[2]

[2] Although the Court of Chancery permitted a preferred stockholder to bring a derivative claim for corporate waste in *Rosan*, 1990 WL 13482, at *7-8, and assumed that a preferred stockholder could bring a waste claim in *Winston v. Mandor*, 710 A.2d 835 (Del. Ch. 1997), both cases pre-date the Supreme Court's decision in *Gheewalla*, which made clear that only those stakeholders who are the residual beneficiaries of any increase in value of a company have standing to bring a derivative action. *See Gheewalla*, 930 A.2d at 101. To the extent *Rosan* and *Winston* could be read as allowing preferred stockholders to bring derivative claims without regard to the economic interests of the preferred stock, defendants respectfully submit that these cases are inconsistent with the Supreme Court's reasoning in *Gheewalla* and should not be followed. Moreover, in *Rosan*, the Court first concluded that the allegations of the complaint met the high pleading standard necessary to sustain a claim for corporate waste, and in *Winston*, the Court allowed the plaintiff to amend his pleadings to attempt to meet this stringent standard. *Cf. Criden v. Steinberg*, 2000 WL 354390, at *3 (Del. Ch. Mar. 23, 2000) (pleading burden for corporate waste is "very rarely satisfied by a shareholder plaintiff") (quotation omitted). Here, MCG does not, and cannot, allege that its derivative claims amount to corporate waste.

The second circumstance is where the economic condition of the corporate enterprise is such that the preferred stockholders, like the creditors of an insolvent corporation, have taken the place of the common stockholders as the "residual beneficiaries of any increase in value." *See Gheewalla*, 930 A.2d at 101-02. This might occur, for example, where a company has insufficient funds to satisfy a preferred stockholder's contractual preference amount (which, as explained *infra* at 9-10, is not the case here). Under such circumstances, the preferred stockholder, like a creditor under *Gheewalla*, would be "the principal constituency injured by any fiduciary breaches that diminish the firm's value," *id*., and the principal constituency benefited by any recovery by the company.[3]

Limiting the ability of preferred stockholders to bring derivative actions to these two scenarios is entirely consistent with the interplay between derivative actions and sound corporate governance. If the holders of preferred stock do not share a common interest in the increased value of the company that might result from derivative litigation, their bringing a suit on behalf of the company can only be seen as officious (and potentially harmful and self-interested) meddling in corporate affairs. Those with a real interest in the Company's prospects—including

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[3] The United States Supreme Court has held that a preferred stockholder would have standing to bring a derivative action under limited circumstances where it is the only stakeholder with a proprietary interest in a corporation who is in a position to protect the corporation. *See Ashwander v. Tenn. Valley Auth.*, 297 U.S. 288 (1936). In *Ashwander*, preferred stockholders of a corporation sued derivatively to enjoin the corporation's performance of an allegedly invalid contract with a federal agency. *Id.* at 316-17. The defendants argued that the preferred stockholders lacked standing to sue derivatively, but the Court determined that the preferred stockholders had standing to sue derivatively because they had "a proprietary interest in the corporate enterprise." *Id.* at 321. The Court noted that the preferred stock had full voting rights and that all shares of the company's common stock were owned by a corporate parent who had participated in the allegedly invalid contractual arrangement. The Court concluded that "[i]t may be, as in this case, that the owner of all the common stock has participated in the transaction in question, and the owners of preferred stock may be the only persons having a proprietary interest in the corporation who are in a position to protect its interests . . . ." *Id.* at 321-22. In this action, Jenzabar has many common stockholders beyond the parties to this case, so MCG is not the only stakeholder in a position to protect corporate interests.

corporate management, the board, or the common stockholders—should be the ones to decide whether to bring an action on behalf of the corporation. As Delaware law recognizes, these parties may validly elect not to pursue a potential corporate claim. *See White v. Panic*, 783 A.2d 543, 550 (Del. 2001). Allowing a preferred stockholder who has no common economic interest in any corporate recovery to pursue derivative litigation where those in control of the corporation have elected not to pursue the corporate claim would permit the preferred stockholder to obtain greater control over the corporation than was actually bargained for and obtained contractually. Further, it would provide the preferred stockholder a means to interfere with corporate governance in a bid to wrest concessions from the company—for example, as here, to pressure corporate management to buy out the preferred stockholder at an inflated price.

III. THE PREFERRED STOCK OWNED BY MCG DOES NOT GIVE MCG THE TYPE OF ECONOMIC INTEREST IN ANY POTENTIAL INCREASE IN JENZABAR'S VALUE THAT IS REQUIRED FOR DERIVATIVE STANDING

As noted in Defendants' Opening Brief, OB at 6 n.4, MCG contends that it owns Jenzabar's Senior Preferred Stock ("Senior Preferred"), which Jenzabar contends has been repurchased by the Company effective April 29, 2009. Either way, it is clear that MCG, as a preferred stockholder, would not share on a pro rata basis in any recovery resulting from the purported derivative claims stated in the Complaint, nor has MCG's economic interest as a preferred stockholder been disadvantaged by virtue of the matters which MCG alleges in its Complaint.

The economic rights of the Senior Preferred as set forth in Jenzabar's Charter are to receive (a) a cumulative preferential dividend of 11% per annum on the Original Senior Preferred Issue Price ($1000 per share), which amounts to $110 per share per annum; and (b) a payment upon liquidation equal to the Original Senior Preferred Issue Price, plus any accrued but unpaid dividends, upon the liquidation, dissolution or winding up of Jenzabar (or upon the repurchase of the Senior Preferred). *See* Compl. Ex. 1, Art. V, § I.A.2(a) (defining the contractual dividend of the Senior Preferred)); *id.* at § I.A.3(a) (defining the liquidation preference of the Senior Preferred; *id.* at § 4 (repurchase).[4] Importantly, after payment of these preferential amounts (and preferences to other classes of preferred stock), "the remaining assets and funds of the Corporation available for distribution to its stockholders shall be distributed among all of the holders of Common Stock of the Corporation on a pro rata basis in proportion to the number of shares of Common Stock held by each at that time." *Id.* Art. V, § I.A.3(b). In other words, after payment of the preferred stock's contractual preferences, the preferred stockholders are not entitled to any pro rata portion of the residual economic value of Jenzabar.

Nor can MCG claim that it has taken the place of the common stockholders as the party with the principal economic interest in pursuing these derivative claims. MCG has not alleged that its economic preferences are in jeopardy as a result of the challenged transactions, nor could MCG even make such a claim. MCG cannot allege that there is any conceivable circumstance in which the Company would be unable to pay all contractual preferences owed to MCG. In fact, in connection with the April 29, 2009 repurchase of the Senior Preferred Stock (which is the subject of some of MCG's claims in this litigation), Jenzabar transferred the entire liquidation value of the Senior Preferred Stock—amounting to more than $6.2 million—to a paying agent for the benefit of MCG. *See* OB at 8 n.7. Further, Jenzabar's Charter provides for the mandatory repurchase of the Senior Preferred Stock upon the earlier to occur of June 30, 2010, or the occurrence of certain events, in each case for a price equal to the Original Senior Preferred Stock Purchase Price plus accrued and unpaid dividends. Compl. Ex. 1, Art. V, § 4(a).

[4] MCG also owns 109,800 shares of Subordinated Preferred Stock ("Subordinated Preferred"). As with the Senior Preferred, the economic rights of this stock are limited to its contractual preference amount ($10 per share plus any accrued but unpaid dividends). Compl. Ex. 1, § I.A.3(a).

Accordingly, the preferred stock will remain outstanding, at most, for less than 6 months, and there is no allegation even suggesting that Jenzabar would not have funds available to make the repurchase on that date, especially given that Jenzabar has deposited over $6.2 million to a paying agent to effect that repurchase.

Because MCG has neither a proportional economic interest with the common stockholders in the appreciation or depreciation in the value of the corporation nor has taken their place as the holder of the principal economic stake in any recovery that may result from the purported derivative claims, MCG lacks standing to pursue them. Indeed, as discussed in Defendants' Opening Brief, OB at 15-16, the fact that MCG is attempting to pursue derivative claims against the individual directors when MCG does not have any right to share in any possible recovery for the benefit of the corporation lays bare that MCG's motive in pursuing the derivative claims is to use the threat of litigation against the individuals as leverage to advance MCG's direct contractual claims or other interests.

CONCLUSION

For the foregoing reasons and those set forth in the briefs previously filed by Defendants, Defendants respectfully submit that MCG lacks standing to maintain any derivative claims and respectfully request that their Motion to Dismiss be granted.

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