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In A Case Of First Impression, Delaware Chancery Court Holds That Preferred Stockholders Have The Right To Bring Derivative Actions

In *MCG Capital Corporation v. Maginn*, Civil Action No. 4521-CC, 2010 Del. Ch. LEXIS 87 (Del. Ch. May 5, 2010), the Delaware Court of Chancery granted in part and denied in part the defendants' motion to dismiss plaintiff preferred stockholder's complaint alleging both derivative and direct claims. In doing so, the court, for the first time, set forth a rule allowing preferred stockholders to bring derivative suits absent an express limitation in the company's articles of incorporation or other appropriate document.

Plaintiff MCG invested in and made loans to defendant Jenzabar, Inc. pursuant to a Preferred Stock and Warrant Purchase Agreement ("Purchase Agreement"), thereby becoming the majority holder of Jenzabar's outstanding warrants and the sole holder of Jenzabar's senior preferred shares. The Purchase Agreement contained certain protective provisions, including the following: (1) Robert Maginn became the Chairman and CEO of Jenzabar and Ling Chai became the President and COO, (2) Jenzabar could not enter into transactions with certain "Affiliates" without MCG's consent, (3) Jenzabar could repurchase MCG's senior preferred stock as long as it had paid its outstanding debt owed to MCG, and (4) Jenzabar's board must consist of five members as follows: one director elected by MCG, two directors elected by Maginn and Chai and two directors elected by mutual agreement between MCG, Maginn, and Chai. At the time of the dispute, the board consisted of Maginn and Chai (self-appointed), Peter Malekian (appointed by MCG), and Joseph San Miguel and Daniel Mills.

The conflict in this case arose from three events. First, salary increases and retroactive bonuses for Maginn and Chai were approved without seeking MCG's approval. Second, another bonus (the "2002 Bonus") was approved without MCG's approval. Third, Jenzabar notified MCG that it intended to repurchase MCG's senior preferred stock. In its complaint, among other things, MCG asserted Jenzabar did not actually wish to repurchase the shares, rather it desired to force MCG into losing its consent rights against the threat of having to sell its shares at an unfavorable price. MCG also alleged Maginn, Chai, and Barr conducted internal board processes in a manner designed to keep non-management members in the dark by, for example, failing to timely circulate board minutes.

Before considering the merits of defendants' motion to dismiss, the court faced the preliminary issue of determining whether MCG, as a preferred stockholder, had standing to bring a derivative claim. It answered in the affirmative. At the time of the complaint, MCG owned preferred stock and common stock warrants, but Delaware law does not allow common stock warrant holders to bring derivative suits. Ultimately, the court concluded that preferred stockholders have standing to bring a derivative claim absent an express restriction or limitation in the articles of incorporation, preferred share designations, or other appropriate document. The court noted that nothing in the derivative suit requirements places a limit on the type or class of stockholders who may bring a derivative claim, nor is there an express distinction between preferred and common stockholders in the relevant authority. In *Matulich v. Aegis Comm. Group, Inc.*, 942 A.2d 596, 601 (Del. 2008), the Supreme Court of Delaware clearly established that any preference or limitation of preferred stock must be expressly and clearly stated and no implied or presumed limitations apply. Because the preferred shares were not limited in any way, the court held that MCG had standing to bring its derivative claim.

Having determined this preliminary matter, the court moved forward with ruling on the defendants' motion to dismiss. The court distinguished between direct and derivative claims, noting that a showing of demand futility is required in order to bring a derivative claims. After lengthy discussion, the court separated the viable claims from those subject to dismissal and allowed the viable claims to move forward.

The decision's significance derives from the explicit holding that preferred stockholders, absent some express limitation, have the same right to bring derivative suits as common stockholders. While other courts have impliedly allowed such claims, this court was the first to expressly set forth the rule. Accordingly, preferred stockholders are provided with a clear guideline as to their ability to assert a suit on the corporation's behalf.

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