FRIED FRANK
M&A/Private Equity BRIEFING™

03/04/2020

Minority Investor "Blocking Rights" May Constitute Control–Skye Mineral

In *Skye Mineral Investors, LLC v. DXS Capital (U.S.) Limited* (Feb. 24, 2020), the Delaware Court of Chancery found, at the pleading stage, that it was reasonably conceivable that the two key minority members of Skye Mineral Partners, LLC ("SMP") had breached their fiduciary duties to SMP and the other members by intentionally using the contractual veto rights they had under SMP's LLC Agreement to harm SMP and increase their own leverage. Also, the court found that members of the group that controlled these minority members, as well as certain affiliates of that group, may have aided and abetted the fiduciary breaches. In addition, the court found that one of these minority members and its authorized observer on the SMP board breached their confidentiality obligations by using information they learned, through the observation right, to advance the member's interests at SMP's expense.

The decision serves as an explicit reminder of the fiduciary and other obligations that LLC members and managers (and their affiliates) may have when the LLC agreement does not clearly and unambiguously provide otherwise. Further, the decision indicates that, under unusual circumstances, minority members may find themselves in the unexpected position of having fiduciary obligations as controllers–if their veto rights under the LLC agreement have put them in a position of "actual control" of the LLC (and particularly if they use that control to advance their own interests while harming the company).

Key Points

- **An LLC agreement can contractually eliminate members' and managers' fiduciary duties, but only through clear and unambiguous language–not "by implication" based on other provisions.** The court held that the provisions in SMP's LLC agreement that permitted the minority members to exercise their veto rights in their "sole discretion," and that eliminated any obligation to present corporate opportunities to the LLC or its members, did not "clearly and unambiguously" more generally eliminate or restrict their fiduciary duties to the LLC and the other members.
- **The decision highlights that, under certain circumstances, a minority investor's blocking rights may constitute actual control over the company, resulting in fiduciary obligations as a controller.** A minority investor's contractual veto rights over specified actions, particularly when they can be exercised in the investor's "sole and absolute discretion," contribute to an inference of control if they "empower [the] investor to channel the corporation into a particular outcome." The court found that SMP's two key minority stockholders may have had "actual control" because their veto rights allowed them "to block *all* of SMP's efforts to finance *any* of its ongoing operations, with either debt or equity"–that is, "the unilateral power to shut SMP down." Importantly, contractual blocking rights, standing alone, do not necessarily lead to controller status. The minority stockholders in this case

Copyright © 2020 Fried, Frank, Harris, Shriver & Jacobson LLP
A Delaware Limited Liability Partnership

exercised their veto rights as part of a "scheme to harm the company" and advance their own interests.

Background. Skye Mineral Investors, LLC and Clarity Copper, LLC (together, the "Majority Members") had a majority ownership interest in SMP. DSX Capital (U.S.) Limited ("DSX") and PacNet Capital (U.S.) Limited ("PacNet") (together, the "Minority Members") held a 28% ownership interest in SMP. The Minority Members were owned and controlled by a number of entities and individuals known collectively as the "Lippo Group." SMPs' Board of Managers was comprised of two managers appointed jointly by the Majority Members and one ("Cooper") appointed jointly by the Minority Members. SMP's LLC Agreement provided the Minority Members with veto rights over, among other things, all debt and equity financings. SMP's only asset was its wholly-owned subsidiary, CS Mining, LLC ("CSM").

In 2014, CSM learned that its untapped mineral deposits were "world class" and, if extracted, would be worth about $600 million. To finance a capital project to make the extraction possible, CSM borrowed $30 million from Noble Americas Corp. ("Noble") in a senior secured financing. Noble was not a traditional lender; it was the exclusive buyer of CSM's minerals. Given Noble's "significant leverages" as CSM's senior secured lender and exclusive customer, the financing agreement with CSM prohibited Noble from selling the Noble Loan to any member of the Lippo Group (the "Insider Sale Prohibition"). The plaintiffs alleged that the Lippo Group, beginning in 2014 after they learned the value of CSM's "world class" minerals, schemed to "wrest control" of CSM from the Majority Members by (i) causing the Minority Members to block SMP from financing its critical capital project; (ii) as SMP struggled financially, entering into discussions with Noble that resulted in CSM waiving the Insider Sale Prohibition; and then, (iii) through its affiliate Waterloo Street Limited, purchasing the Noble Loan at a substantial discount, forcing CSM into bankruptcy in June 2016, and buying CSM's assets at a steep discount in the bankruptcy sale.

Discussion

The court ruled that the LLC manager appointed by the Minority Stockholders (Cooper) had fiduciary duties and may have breached them. The court reaffirmed that managers of a Delaware LLC owe traditional fiduciary duties of care and loyalty to the LLC and its members unless the LLC Agreement, through "clear and unambiguous language," restricts or eliminates those duties. The LLC Agreement provided that the SMP managers had the same fiduciary duty to SMP and its members that a director of a Delaware corporation would have to the corporation and its stockholders (assuming the corporation had exculpatory charter provisions as authorized under DGCL Section 102(b)(7)). The Lippo Group argued that Cooper had no fiduciary duties because the LLC Agreement specifically allowed SMP's managers "to engage in whatever activities [they and their affiliates] may choose" without having an obligation to share those opportunities with SMP. The court found that language insufficient as a disclaimer of general fiduciary duties. The court observed that, as alleged, Cooper: (i) through his role as an SMP Board member, learned that CSM's assets were worth $600 million and shared that information with the Lippo Group while concealing it from SMP's other Board members; (ii) along with the Minority Members, filed a lawsuit seeking to enforce the Minority Members' veto rights "to cut off SMP from capital"; (iii) "lied" to SMP's other Board members when they asked whether he was involved in any discussions regarding a purchase of the Noble Loan; (iv) refused to attend SMP Board meetings, with the goal of preventing SMP from responding to its liquidity crisis; and (v) "used his position on the Board to engage in [acts which] harm[ed] SMP and benefitt[ed] the Lippo Group." The court noted that Cooper, in an email to "N" (who was the "representative" of the Lippo Group in its efforts to purchase the Noble Loan–as described below), encouraged pursuing a purchase of the Noble Loan and stated: "Then we can sit back and hold our position and when this collapses we have the first lien and can buy it out of bankruptcy very cheap."

The court wrote: "When a fiduciary, in his own words, intentionally 'sits back' while his company 'collapses' so that another to whom he is beholden can buy the company's assets 'out of bankruptcy very cheap,'" it is reasonably conceivable that (a) he has breached the duty of loyalty and (b) his breach "exceeds the scope of behavior the corporate opportunity doctrine prohibits such that the contractual corporate opportunity carve-out does not bar the claim."

The court ruled that the Minority Members (DSX and PacNet) had fiduciary duties and may have breached them. The court ruled that the Minority Members (i) had common law fiduciary duties that the LLC Agreement did not contractually eliminate; and (ii) may have had fiduciary duties by virtue of their (allegedly) having exercised "actual control" over SMP through their Blocking Rights. The LLC Agreement provided that no member would have any fiduciary obligations to the LLC or the other members "insofar as making other investment opportunities available to the Company or to the other members." Also, the LLC Agreement provided that veto rights granted under the Agreement could be exercised in the Minority Members' "sole and absolute discretion." The plaintiffs argued that these provisions eliminated the members' fiduciary duties. The court found, to the contrary, that "[t]he clear import of both Sections…is that the [Agreement] modifies, but does not eliminate, common law fiduciary duties for members." The court stated: "If the [Agreement]'s drafters wished to exempt members from the fiduciary duty of loyalty, they could do so only with express disclaimer language, not 'by implication.'" With respect to the "sole discretion" provision, the court wrote: "[The allegation that] member fiduciaries took a bad faith action to injure SMP for their own personal advantage…implicates the core aspect of the duty of loyalty, which the 'sole discretion' language cannot coyly eliminate." To the extent that an agreement "purports to insulate a fiduciary from liability even for acts of bad faith it should do so in the most painstakingly clear terms."

The plaintiffs also contended that the Minority Members had "actual control" over SMP and therefore had fiduciary duties as controllers. The court agreed, based on a consideration of "DXS and PacNet's Blocking Rights *in context with* the Noble Loan." The Blocking Rights appear to have "amounted to a self-destruct button which allowed DXS and PacNet to 'wield control' by driving SMP into the ground if it suited their interests," the court wrote. "Once SMP's operating subsidiary took on the Noble Loan and started [the capital project], Plaintiffs deserve an inference that SMP would require imminent, substantial and ongoing capital contributions to fund that all-important project and service that debt." Under these circumstances, it was reasonably conceivable that the Blocking Rights "amounted to an on/off switch for SMP that could be, and allegedly was, manipulated by [the Minority Members] to serve their interests at the expense of SMP." The court acknowledged that a blocking right, standing alone, typically would not support a reasonable inference of actual control. In this case, however, the court stated, the plaintiffs "alleged more"–they alleged that the Minority Members "participated in a concerted effort to place SMP in a precarious financial condition (*i.e.*, a conspiracy to harm...), and then exercised their leverage with the Blocking Rights to steer CSM off the cliff into the bankruptcy ravine below." The Blocking Rights allowed the Minority Members "to block *all* of SMP's efforts to finance *any* of its ongoing operations–with either debt or equity." That, in turn, led to the Noble Loan default, the amendment that eliminated the Insider Sale Prohibition, and then the acquisition of the Noble Loan by the Lippo Group–indicating that the Minority Members had "the unilateral power to shut SMP down–full stop."

The court ruled that the defendants affiliated with the Minority Members' controller (the "Lippo Group") may have aided and abetted the Minority Members' and Cooper's fiduciary breaches. Aiding and abetting requires "knowing participation" in fiduciary breaches, which "requires the plaintiff to well plead scienter" by the alleged aider and abetter. Scienter is "actual or constructive knowledge that [the] conduct was legally improper, and…act[ing] with an illicit state of mind." Also, the court noted, the

knowledge of an agent acquired within the scope of his or her authority, and the acts of an agent within that scope, can be imputed to the principal. The court found that the facts pled supported a reasonable inference that Cooper and the Minority Stockholders were acting as agents for their principals (that is, their parent company and sister company) who were Lippo Group members. While the plaintiffs argued that no facts were pled that indicated that these principals consented to Cooper's and the Minority Stockholders' actions, the court found that it was reasonable to infer the consent "[g]iven the overall ownership and organizational structure, as alleged." Also, the court found that "N" (DSX's designated observer on the SMP Board), although not a principal, knowingly participated given that he "personally assisted Cooper as he engaged in the Unauthorized Acts." In addition, the court found that Waterloo, although not a principal, knowingly participated given that "it was the entity the Lippo Group used to acquire the Noble Loan."

The court ruled that the facts pled did not support a reasonable inference that SMP's lender (Noble) aided and abetted Cooper's or the Minority Stockholders' fiduciary breaches. The plaintiffs argued that Noble was motivated to sell the Noble Loan to the Lippo Group out of self-interest and thus knowingly participated in the fiduciary breach related to that sale. The court stated that the facts alleged did not indicate that Noble had "attempted to create or exploit conflicts of interest at the SMP level." The court observed that Noble was "in no way affiliated with the Lippo Group" and was not in a principal-agency relationship with any of its members such that their knowledge of the fiduciary breaches could be imputed to Noble. The court viewed Noble–"a third party lender (and customer) that got stiffed for $30 million–as acting based on its own "commercial incentives" when it demanded the elimination of the Insider Sale Prohibition and sold the Noble Loan to the Lippo Group. Noble's not having "open[ed] a bidding process" for the sale of the Noble Loan by advising the Majority Stockholders that it was willing to sell the loan at a substantial discount was "a far cry from knowing participation in a breach of fiduciary duty," the court wrote.

The court ruled that it was reasonable to infer that the Minority Member (DSX) and its board observer ("N") breached their confidentiality obligations. The LLC Agreement gave DSX the right to appoint an observer to the SMP Board, subject to their "promise to hold in confidence and trust all information" they learned "in connection with [their] rights under [the LLC Agreement]." DSX appointed "N," who was affiliated with the Lippo Group (and who acted as Waterloo's "representative" in its dealings with CSM after Waterloo purchased the Noble Loan). The court found it reasonably conceivable that DSX and N used their observation rights to learn about the inherent value of CSM's "world class" assets and then leaked that information to non-SMP members affiliated with the Lippo Group who were "positioned to value and then acquire the Noble Loan based on that confidential information, and then to exploit the Noble Loan to harm SMP." The court emphasized that the Cooper-N Email, "specifically, supports a reasonable inference that [N] was actively trying to advance the Lippo Group's interests at SMP's expense."

Practice Points

- ***Drafters of LLC agreements should use clear and unambiguous language to define the members' and managers' fiduciary duties.*** If it is intended that there be no fiduciary duties, there should be an express disclaimer of all fiduciary duties. It should not be assumed that a disclaimer of specified fiduciary duties will constitute a disclaimer of others or of fiduciary duties generally. It should not be assumed that providing that a member can exercise consent, veto or other rights in its "sole and absolute discretion" will constitute a disclaimer of fiduciary obligations. Drafters should make absolutely clear what fiduciary duties are being disclaimed; seek to ensure that other provisions do

not suggest that additional fiduciary duties are operative; and make clear the interrelationship of any provisions that are related to fiduciary duties.

- ***When providing minority stockholders with blocking rights, carefully consider whether there should be exceptions.*** (a) Minority stockholders should consider whether the blocking rights they negotiate for give them, generally or under certain circumstances, "actual control" such that they may have fiduciary duties as controllers. In general, blocking rights in and of themselves should not create control status; however, a careful evaluation of all the facts and circumstances is required. (b) Majority stockholders should consider whether the blocking rights granted to minority stockholders will give the minority stockholders so much leverage that other negotiated-for majority stockholder protections may become ineffective as a practical matter. For example, in *Skye Mineral*, the minority stockholders' right to block all debt and equity financing meant that (i) the court viewed them as controllers once the company was financially struggling and (ii) as a practical matter, once the company faced default of its debt, it had to agree to waive the prohibition in the debt against its sale to affiliates of the Minority Stockholders. To protect against (ii), an LLC agreement might provide for exceptions to the blocking right–for example, at a minimum, that, in the event the company faces default, it can raise funds from its members (with each having a pro rata right of participation) free of the blocking right; or, alternatively, that in those circumstances the board will have the authority (irrespective of blocking rights) to conduct a sale process.

* * *

Fried Frank M&A/PE Group:

Amber Banks (Meek)	Erica Jaffe	Robert C. Schwenkel
Andrew J. Colosimo	Randi Lally	David L. Shaw
Warren S. de Wied	Mark H. Lucas	Peter L. Simmons
Steven Epstein	Scott B. Luftglass	Matthew V. Soran
Christopher Ewan	Brian T. Mangino	Steven J. Steinman
Arthur Fleischer, Jr.*	Shant P. Manoukian	Gail Weinstein*
Andrea Gede-Lange	Philip Richter	Maxwell Yim
David J. Greenwald	Steven G. Scheinfeld	

This Briefing is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this Briefing, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

New York

Amber Banks (Meek)	+1.212.859.8522	amber.meek@friedfrank.com
Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Warren S. de Wied	+1.212.859.8296	warren.dewied@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr.*	+1.212.859.8120	arthur.fleischer@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Erica Jaffe	+1.212.859.8442	erica.jaffe@friedfrank.com
Randi Lally	+1.212.859.8570	randi.lally@friedfrank.com
Mark H. Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Scott B. Luftglass	+1.212.859.8968	scott.luftglass@friedfrank.com
Shant P. Manoukian	+1.212.859.8617	shant.manoukian@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Peter L. Simmons	+1.212.859.8455	peter.simmons@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein*	+1.212.859.8031	gail.weinstein@friedfrank.com
Maxwell Yim	+1.212.859.8214	maxwell.yim@friedfrank.com

Washington, D.C.

Andrea Gede-Lange	+1.212.859.8862	andrea.gede-lange@friedfrank.com
Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com

*Senior Counsel