Delaware Decision Calls Into Question the Value of Preferred Stockholder "Blocking Rights"

By:Mary Beth Kerrigan
February 01, 2014

In *Fletcher International, Ltd. v. Ion Geophysical Corporation* (December 4, 2013), the Delaware Court of Chancery determined the amount of damages owed to the plaintiff, Fletcher International, Ltd. ("Fletcher") in connection with the failure of the defendant, Ion Geophysical Corporation ("Ion") to obtain Fletcher's consent to a financing transaction. In order to determine the appropriate damages amount, the Court of Chancery conducted a hypothetical negotiation between the parties to allocate bargaining power and determine the consideration Ion would have provided Fletcher in order to obtain its consent had Ion requested Fletcher's consent at the time of the financing.

Background

In 2009, Ion faced financial difficulty and potential bankruptcy. To address these difficulties, Ion entered into an agreement with BGP Inc. ("BGP") to form a joint venture. As part of this joint venture, Ion received $40 million in the form of a bridge financing from the Bank of China, including a $10 million convertible promissory note issued by Ion's subsidiary, ION International S.ar.L. The overall BGP transaction was valued between $195 million and $245 million. Ion had an existing credit facility pursuant to which it had a revolving credit line with several other investors and the Bank of China provided its bridge financing by becoming a party to the existing loan facility. Prior to the $40 million bridge financing, Fletcher had purchased shares of Ion preferred stock, the terms of which included stockholder "blocking rights" requiring Ion to obtain Fletcher's consent if any subsidiary of Ion issued any securities. Fletcher's consent was only required for the $40 million portion of the overall transaction (the larger BGP transaction did not require Fletcher's consent).

Ion's management team determined that the transaction with BGP was in the best interests of the existing lenders and would permit Ion to repay the existing lenders. The existing lenders unanimously approved the BGP transaction and received a fee in exchange for their consent equal to 25 basis points in excess of the amount of the loan outstanding. Ion finalized the term sheet with BGP and, in October 2009, when it publicly announced that it had entered into a binding term sheet with BGP, Ion's stock price (and therefore Fletcher's investment) was positively affected (the stock price increased by 47% and Fletcher purchased additional Ion stock). Notwithstanding the positive impact of the term sheet, in November 2009, Fletcher brought a complaint against Ion in the Delaware Court of Chancery (i) claiming that its right to consent to the transaction had been violated; (ii) seeking an injunction of the BGP transaction; and (iii) seeking an award of damages, arguing in part that the additional debt incurred would decrease the value of its preferred stock.

In March 2010, the Court of Chancery issued a decision stating that despite the fact that Fletcher had a "reasonable likelihood of success" with respect to its claim that Ion had violated its right to consent to the transaction, the "balance of the equities weighed against granting injunctive relief". In other words, Fletcher did not have the right to actually veto or block the transaction. Instead, the Court determined that Fletcher's appropriate remedy was for breach of contract. In its decision, the Court cited three reasons for refusing to grant injunctive relief: (i) an injunction may have prevented the transaction with BGP from occurring which would have resulted in Ion defaulting on its existing obligations with the existing lenders; (ii) Fletcher was unlikely "to suffer irreparable harm in the absence of the injunction" since damages could be determined; and (iii) Fletcher did not promptly pursue these consent rights in a manner which would have been consistent with its current position. The Court therefore denied the summary judgment motion.

In May 2010, the Court of Chancery addressed outstanding issues which had been previously reserved, holding that Fletcher did have a right to consent to any issuance of a security by a wholly-owned subsidiary of Ion, the promissory note issued by the subsidiary was a security, and that Ion had indeed violated Fletcher's right to consent to the issuance of this security.

The Court then was left with determining Fletcher's damages and used hypothetical negotiations between the parties to calculate these damages.

Legal Analysis

The Court requested that both parties present evidence to the Court to calculate what consideration Fletcher would have received had Ion requested its consent and been required to bargain with Fletcher in order to obtain such consent prior to entering into the BGP loan transaction. During the hypothetical, Fletcher argued that had it been given the opportunity to negotiate back in 2009, it would have taken a very strong position and would have been willing to refuse to give its consent, even if the result was blocking the BGP transaction in its entirety. The Court did not think that this position was realistic, even as Fletcher tried to claim that since Ion had no other options, Fletcher would have been able to receive anything they requested in order for Ion to obtain its consent. The Court did not accept Fletcher's position that Ion would have given $78 million to Fletcher in exchange for its consent on a $40 million transaction. The Court instead focused on the fact that there were more parties involved in the negotiations than just Fletcher and Ion. Even if Ion had been a weak negotiator and willing to accept any of Fletcher's terms, BGP and the existing lenders would have clearly been involved in any negotiations with Fletcher. The Court determined that both BGP and the existing lenders had significantly more negotiating leverage than Fletcher and referred to Fletcher's position as a "cartoonish portrayal of its own negotiation position." Nevertheless, the Court determined that Fletcher would have at least been in a position to extract a reasonable amount of consideration from Ion in exchange for its consent to the BGP transaction. In order to determine the true damages to Fletcher, the Court compared the consent fees that the existing lenders had received in connection with their consent to the BGP transaction and prior transactions to what Fletcher should have received.

The Court reviewed the expectation of damages, summarizing that in a breach of contract claim, damages "are determined by the reasonable expectation of the parties before the breach occurred." The Court stated that typically, consent rights are seen as "protective devices meant to shield the holder of the right against being harmed by a new transaction that is adverse to its interests" and concluded that the BGP transaction "benefited Fletcher immensely, and therefore Fletcher suffered no damage as a result of its consummation." Despite the fact that the Court determined that no damages resulted, the Court still concluded that Fletcher was entitled to have its "*reasonable* expectations honored." The Court calculated Fletcher's damages based upon the anticipated result of the hypothetical negotiation between all parties involved before the closing of the BGP transaction. In determining this amount, the Court strongly considered the bargaining power of all of the parties involved and concluded that BGP had the most leverage of all the parties in the transaction. Fletcher and Ion had significantly less leverage than not just BGP but also the existing lenders. If the transaction did not close, Ion would have been facing bankruptcy.

Conclusion

After analyzing all the facts, the Court of Chancery concluded that Fletcher would not have had the negotiating leverage to extract a consent fee from Ion which was significantly larger than any consent fee the existing lenders had been previously able to obtain in connection with a prior amendment to the existing lender's loan facility. The Court therefore awarded Fletcher damages in the amount of $300,000, which was equal to a consent fee of 75 basis points over the amount of the $40 million financing transaction Fletcher had the contractual right to approve.

This case serves as an important reminder for practitioners on how damages may be imposed by a Delaware court if a party violates another party's contract right to consent to certain transactions and fundamentally calls into question the meaning of "blocking rights", suggesting that if a contract remedy is appropriate, that may be the final remedy (in lieu of equitable relief). While the Court in the Fletcher decision analyzed the issue in the context of the issuance of a security, preferred stockholders and their counsel should be mindful that following Fletcher, preferred stockholders may not in fact enjoy the benefits of what they previously understood to be "blocking rights" in various situations, including, for example, the sale of a company.

For more information on this topic, please contact **Mary Beth Kerrigan**.