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Delaware Court of Chancery Addresses Cram-Down Financing and Fiduciary Duties in Challenge to Dilutive Preferred Stock Round

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KEY POINTS

- In *Guilbeau v. Footprint International Holdco, Inc.*, the Delaware Court of Chancery held that entire fairness review applied to a cram-down preferred stock financing because five of 10 directors were conflicted, including an officer-director whose employment depended on the transaction's survival.
- A pay-to-play financing that eliminates nonparticipating stockholders' contractual protections is not insulated from entire fairness scrutiny by nominal equal access, particularly where the lead investors pre-allocated 90% of the round, gave other investors only three weeks to decide, and conditioned data room access on prior subscription.
- A two-year pattern of undisclosed governance agreement amendments — each technically authorized but culminating in elimination of Class A protections — supported an inference of unfair dealing under the fair dealing prong of the entire fairness test.
- The court dismissed the controlling stockholder claim against Cleveland, holding that a 26.4% voting block did not support a pleading-stage inference of transaction-specific control given other large institutional blocks and governance terms limiting Cleveland to one board designee.
- Fund sponsors face aiding and abetting exposure when board designees approve transactions that benefit their affiliated funds, as the designee's knowledge is imputed to the fund and participation is inferable from the employment or affiliation relationship.

OVERVIEW

In *Guilbeau v. Footprint International Holdco, Inc.*, the Delaware Court of Chancery denied in large part a motion to dismiss fiduciary duty claims arising from a dilutive preferred stock financing that eliminated the contractual protections of early-stage investors. The decision addresses several issues of significance to private equity sponsors, portfolio company boards, and minority preferred stockholders, including the standard for transaction-specific controlling stockholder status, the circumstances under which entire fairness review applies to a cram-down financing, the conditions under which a pay-to-play structure becomes actionably coercive, and the scope of aiding and abetting liability for funds that act through affiliated board designees.

BACKGROUND

Footprint International Holdco, Inc. is a Delaware corporation that develops biodegradable food packaging. Between 2019 and 2020, approximately 80 friends-and-family investors purchased shares of Class A nonparticipating preferred stock at $25,000 per share, raising roughly $90 million. A series of governance

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agreements granted the Class A stockholders a 1.4x liquidation preference, priority in the distribution waterfall, and the right to designate one director to the board.

In November 2020, three institutional investors, Cleveland Avenue, LLC (Cleveland), Olympus Growth Fund VII, L.P. (Olympus), and Movendo Capital B.V. (Movendo, together with Cleveland and Olympus, the Funds) invested $150 million to acquire Class A stock. Each Fund received the right to designate a director to the 10-member board, and Cleveland's CEO served as board chair. The governance agreement was amended and restated in connection with the Funds' investment, and that third iteration was the last version of the governance agreement that the company provided to the Class A stockholders contemporaneously with its execution. Over the following two years, the company purported to amend the governance agreement five additional times without informing the Class A stockholders and without their consent. As the court explained in a companion ruling dismissing the plaintiff's contract claims, the governance agreement permitted these amendments and did not require notice to, or the consent of, the individual Class A stockholders.

Following the collapse of a planned SPAC merger in December 2022, the company faced a severe liquidity crisis. In January 2023, the Funds provided bridge loans totaling approximately $71 million. The board formed a three-member special committee to consider financing proposals from related-party investors, but gave the committee only the power to recommend, not to approve or veto, any proposal.

In March 2023, the board rejected without meaningful engagement financing proposals from Shuler Capital Corp. (at a $670 million valuation), Apollo Global Management (at a $1 billion valuation), and Ariel (at a $390 million pre-money valuation). Two days after the committee declined to pursue the Shuler proposal, the board approved a $500 million Class F preferred stock financing led by the Funds at a $500 million pre-money valuation (the Class F Financing). The Class F Financing conferred significant nonratable benefits on the Funds and ZenCap Holdings FP, LLC (a ZenCap-affiliated entity that nominated three board directors), and the Koch family (holders of a blocking right), including favorable stock conversions, share redemptions, and enhanced liquidation terms. All Class A protections were eliminated in connection with the financing and the Class A director was removed. Following closing, the board shrank from 10 to four members, all Fund-affiliated.

The plaintiffs, who were original Class A investors, brought suit asserting breach of fiduciary duty against the directors, breach of duty as a controlling stockholder against Cleveland, aiding and abetting against the Funds, civil conspiracy, unjust enrichment, and tortious interference with prospective business relations. The defendants moved to dismiss under Court of Chancery Rule 12(b)(6).

DECISION

CONTROLLING STOCKHOLDER CLAIM AGAINST CLEVELAND

The court dismissed the claim that Cleveland acted as a controlling stockholder in connection with the Class F Financing. Because the conflict safe harbor amendments to Section 144 of the Delaware General Corporation Law (DGCL) (the "Safe Harbor Amendments"), which prospectively codify the definition of "controlling stockholder," do not apply to actions pending on February 17, 2025, the court applied prior Delaware law, under which a minority stockholder is a fiduciary only if it exercises actual control over the corporation generally or over the specific transaction at issue. Applying that multifactor test, the court held that Cleveland's 26.4% voting block, though significant, did not support a pleading-stage inference of transaction-specific control, given the other large

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institutional blocks held by Olympus and Movendo, governance terms that entitled Cleveland to only one designee within a 10 director slate, and the absence of any allegation that Cleveland used its creditor position or other relationships to steer the company into the Class F Financing.

BREACH OF FIDUCIARY DUTY CLAIMS AGAINST THE DIRECTORS

The court held that entire fairness review, rather than the business judgment rule, applied to the Class F Financing because the complaint adequately alleged that the board lacked a disinterested and independent majority. For purposes of the motion to dismiss, the court treated four of the 10 directors as facially independent and disinterested and inferred that four others were conflicted dual fiduciaries. The court also inferred that the company's CTO and co-founder was nonindependent, because the Class F Financing was essential to the company's survival and therefore to his continued employment, and because after closing he would owe a duty of obedience to a board majority controlled by the Funds. Those pleading-stage inferences left five of 10 directors conflicted, which was sufficient to rebut the business judgment rule.

The court also found a pleading-stage inference of financial unfairness, noting that the Class F Financing used a $500 million pre-money valuation while the company's own bridge loans and the Apollo proposal had used a $1 billion valuation just months earlier.

On the procedural side, the court held that the financing was inferably coercive because nonparticipating stockholders could not preserve the status quo: declining to invest meant losing their Class A protections. Distinguishing the *WatchMark* line of cases, in which a genuine equal opportunity to participate in a pay-to-play round defeated a fiduciary claim, the court explained that nominal equal access cannot insulate a structurally coercive transaction, and that the access here was not genuinely equal in any event, because the Funds pre-allocated 90% of the round to themselves, gave other investors only three weeks to decide, conditioned data room access on prior subscription and funding, and retained the right to exclude any investor for any reason. The court treated the term sheet's nondisclosures, together with the pattern of undisclosed governance-agreement amendments that culminated in the elimination of the Class A protections, as further support for an inference of unfair dealing under the fair dealing prong of the entire fairness test.

AIDING AND ABETTING CLAIMS AGAINST THE FUNDS

The court sustained the aiding and abetting claim against the Funds. Because each Fund employed or was closely affiliated with its board designee, knowledge of the director's breach was imputed to each Fund, and active participation was inferable from those relationships and from the Funds' role in formulating and promoting the Class F Financing.

TAKEAWAYS

- **Even contractually permitted amendments to governance documents can support an inference of unfair dealing when made serially and in secret.** The court did not find, and its companion contract ruling confirms, that the company breached any notice or consent rights when it amended the governance agreement five times; the agreement permitted the amendments, and the court declined to imply a notice or consent requirement under the implied covenant. What mattered for the fiduciary analysis was the manner of the amendments. A two-year pattern of undisclosed changes, culminating in a version that eliminated the Class A protections and that the stockholders first saw when it was attached to the financing term sheet, supported an inference of procedural unfairness. The lesson is one of transparency rather than contract mechanics: where a company

quietly reshapes the documents that define minority rights and then relies on those changes to extinguish those rights, the secrecy itself becomes evidence, even where every amendment was technically authorized.

- **With Section 144 now in effect, a conflicted-board financing should be built to fit the statutory safe harbor.** *Footprint* was decided under prior law, so the conflicted board majority triggered entire fairness and a committee that could only recommend, not veto, provided little protection. For transactions approved on or after the effective date of the Safe Harbor Amendments, Section 144 of the DGCL supplies the operative playbook. Where, as here, there is no controlling stockholder but a majority of the approving board is conflicted, Section 144(a) allows the transaction to obtain business-judgment-type protection if it is approved by a committee of at least two disinterested and independent directors who are informed of all material facts and act in good faith, or by an informed, uncoerced vote of the disinterested stockholders.
- **Pay-to-play structures that eliminate the status quo may be coercive.** A financing round that forces preferred stockholders to choose between investing or losing their contractual protections is not insulated from entire fairness scrutiny by nominal equal access. Where the opportunity to participate is not genuinely equal in terms of information, timing, and access, the inference of coercion is only strengthened.
- **Officer-directors are generally not independent when their employment depends on the transaction.** A senior officer whose continued employment is tied to the survival of a transaction will be treated as nonindependent at the pleading stage, particularly where, after closing, the officer will owe a duty of obedience to a board majority aligned with the interested parties.
- **Fund sponsors may face aiding and abetting exposure when they act through board designees.** Where a fund's designee approves a transaction that benefits the fund at the expense of minority stockholders, the designee's knowledge is imputed to the fund and participation is inferable from the employment or affiliation relationship. Because the fund's exposure rises and falls with the underlying director breach, the most effective protection is to prevent the breach in the first place: run a genuine, well-documented, and fully informed approval process (now, the Section 144 safe harbor), consider recusal or screening of conflicted designees, and confirm that the designee's conduct can withstand entire fairness scrutiny.

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