what appears to me to be the unambiguous right of defendants to advancement after May 1992, one cannot conclude that any remedy would be appropriate even if the August 1991 undertaking were thought to be a nullity. Thus, I conclude that: (1) defendants now have an enforceable right to advancements, (2) defendants have had such a right since August 1991, and (3) the failure to give the appropriate undertaking prior to August 1991 itself resulted in no injury or cost to ESLP.

I V.

Plaintiffs raise three general objections to ESLP's payment of advances, all of which lack merit and can be summarily rejected.

First. Plaintiffs argue that any payment of indemnification to defendants must be approved by the limited partners pursuant to Section 6.10 of the Partnership Agreement. Section 6.10 provides:

> Notwithstanding anything to the contrary in this Agreement, the General Partner *shall not sell or otherwise dispose of, any of the assets or properties of the partnership to the General Partner* or any Affiliate thereof, other than upon dissolution and termination of the Partnership, *without the consent of the Limited Partners*. (emphasis added).

Plaintiffs claim that this provision means that Spectacular cannot make any payments to RCMH, Green, or McManus for indemnification or otherwise, without the approval of the limited partners. This is an obvious misreading of the Partnership Agreement that requires only brief comment.

The Partnership Agreement provides that "[Spectacular] shall have full, exclusive and complete discretion in the management and control of the affairs of the Partnership." (Section 6.01). Spectacular is fully empowered to pay the obligations of the partnership, including those arising from Section 6.07(a), without plaintiffs' approval. In fact, Spectacular has paid millions of dollars of partnership funds to RCMH since 1990 for its production and operation of the Easter Show, without plaintiffs' approval or objection on that ground.

Second. Plaintiffs argue that Section 6.07(a) only allows the creation of reserves for legal expenses that have already been incurred and that Spectacular's June 1991 creation of a $250,000 reserve to pay legal fees it expected ESLP to incur in the future was, therefore, a breach of duty. I find no such limitation upon the General Partners' management discretion to provide for reasonably foreseeable part-

nership obligations in Section 6.07 or anywhere else in the Partnership Agreement. As in other matters, the General Partner must exercise informed judgment and since, in this instance, its own interests are involved, its judgments will be subjected to a test of substantive fairness, but neither of these standards is even arguably violated by the establishment of the reserve here mentioned. The 1991 settlement statement shows that by June 28, 1991, defendants, including ESLP itself, had incurred legal expenses of $219,000, thus only $31,000 of the $250,000 reserve was for future expenses, a small amount considering the fact that defendants incurred over $980,000 in legal expenses in the subsequent twelve months. The creation of this reserve was not unauthorized or a breach of fiduciary duty.

[5] Third. Plaintiffs argue that it is contrary to public policy and inequitable for ESLP to advance litigation expenses of the general partner and its affiliates because the plaintiffs are ESLP's limited partners and their claims are for alleged breaches of fiduciary duty. There is no support for this position in DRULPA, the common law of Delaware or, importantly, the parties' contract. DRULPA explicitly authorizes limited partnerships "to indemnify and hold harmless any partner or other person . . . *against any and all claims and demand whatsoever.*" *See* 6 *Del. C.* § 17-108 (1990). The public policy of Delaware is to allow advancement, if the partnership agreement so provides, even in cases in which the plaintiff is a limited partner and the claims are for breach of fiduciary duty. This has regularly been done under corporate indemnification provisions which are somewhat more restrictive than DRULPA. Notably while the ESLP Partnership Agreement restricts the indemnification right in this way, it does not similarly restrict the advancement provisions of Section 6.07(a).

V.

[6] Summary judgment may be granted when there exists no genuine issue of material fact with regard to the issues to be decided and the movant is entitled to judgment on those issues as a matter of law. *Brown v. Ocean Drilling & Exploration Co.*, Del. Supr., 403 A.2d 1114, 1115 (1979); *Hartman v. Buckson*, Del. Ch., 467 A.2d 694 (1983). In this case, the undisputed facts show, for the reasons outlined above, that defendants must be granted partial summary judgment, declaring that they are entitled to the advancement of reasonable litigation expenses incurred by them, pursuant to the indemnification provisions of the ESLP Partnership Agreement.

Plaintiffs appear to wish to reserve the right to challenge the reasonableness of the amounts advanced. This matter, if it is to be pressed, raises questions of fact and thus precludes entry of a final judgment in this case at this time. For the guidance of counsel, I note that I interpret the requirement of reasonableness to incorporate the following three inquiries: were the expenses actually paid or incurred; were the services that were rendered thought prudent and appropriate in the good-faith professional judgment of competent counsel; and were charges for those services made at rates, or on a basis, charged to others for the same or comparable services under comparable circumstances?

Defendants may submit an implementing form of order on notice.

HB KORENVAES INVESTMENTS, L.P. v. MARRIOTT CORP.

No. 12,922

Court of Chancery of the State of Delaware, New Castle

June 9, 1993

Plaintiffs, four institutional investors who acquired more than fifty percent of Marriott Corporation's preferred stock brought action to enjoin payment of a special dividend to the common stockholders of Marriott following a corporate reorganization. Marriott was obliged to pay annual dividends on its preferred stock before it could pay any dividends on its common stock. In addition to the special dividend, Marriott announced that following the special dividend on its common stock, it would indefinitely suspend the dividends on its preferred stock. Plaintiffs' amended complaint alleged that these planned transactions constituted (1) a breach of fiduciary duties owed to them as holders of preferred stock, (2) a breach of contractual obligations, and (3) fraud upon them and other holders of preferred stock by a public statement made by defendants denying payment of dividends on its common stock. Defendants, Marriott Corporation and its individual directors, moved to dismiss the complaint.

The court of chancery, per Chancellor Allen, declined to address the breach of contract and fraud claims and held that Mariott's directors owed no duty of loyalty to holders of the preferred stock. The court concluded that plaintiffs' rights were not equitable with respect to the proposed special dividend, but they were contractual in nature. Thus, questions of liability were to be evaluated under contractual law governing rights of the preferred. Applying this standard, the court found Mariott's certificate of designation expressly contemplated the payment of a special dividend of this type, while simultaneously supplying a device to protect the preferred stockholders in the event such a dividend is paid. Thus, defendants motion to dismiss was granted.

1. Pretrial Procedure ⟹ 624, 687

The legal test that governs the disposition of a motion to dismiss is: if under any state of facts reasonably inferable from the facts that have been alleged plaintiff would be entitled to a judgment, then plaintiff should be accorded the right to discover and present evidence in support of its claim.

2. Pleading ⟹ 354(1)

A dismissal is appropriate where the law recognizes the existence of no wrong even assuming all of the facts alleged can be proven and all inferences are drawn in plaintiffs' favor.

3. Corporations ⟹ 1.5(1)

A court of equity will in certain instances ignore the legal fiction of corporate personality.

4. Corporations ⟹ 62, 156

Rights of preferred stock are primarily but not exclusively contractual in nature. The special rights, limitations, etc. of preferred stock are created by the corporate charter or a certificate of designation which acts as an amendment to a certificate of incorporation. Thus, to ask what are the rights of the preferred stock is to ask what are the rights and obligations created contractually by the certificate of designation.

5. Corporations ⟹ 156

In most instances, given the nature of the acts alleged and the terms of the certificate, this contractual level of analysis will exhaust the judicial review of corporate action challenged as a wrong to preferred stock.

6. Corporations ⟹ 156, 307

Due to the fact that the holder of preferred stock is in the exposed and vulnerable position vis-à-vis the board of directors that all stockholders occupy, it has been recognized that directors may owe duties of loyalty and care to preferred stock.

7. Corporations ⟹ 310(1)

In certain circumstances, there is a burden on the board to demonstrate that the appointment of consideration that it negotiated and presented to the holders of common stock is not unfair to the preferred stock.

8. Corporations ⟹ 310(1)

The question of whether duties of loyalty are implicated by corporate action affecting preferred stock is a question that demands reference to the particularities of context to fashion a sound reply.

R. Franklin Balotti, Esquire, and Gregory V. Varallo, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and Ronald S. Rolfe, Esquire, Joseph R. Sahid, Esquire, Lewis J. Liman, Esquire, and Michael D. Nolan, Esquire, of Cravath, Swaine & Moore, New York, New York, of counsel, for plaintiffs.

Michael D. Goldman, Esquire, and Stephen E. Norman, Esquire, of Potter, Anderson & Corroon, Wilmington, Delaware; Peter L. Winik, Esquire, and Arne M. Sorenson, Esquire, of Latham & Watkins, Washington, D.C., of counsel; and Frederic J. Zepp, Esquire, and Michael K. Hertz, Esquire, of Latham & Watkins, New York, New York, for defendants.

ALLEN, *Chancellor*

Plaintiffs claim that the proposed distribution of a special dividend to the common stockholders of Marriott Corporation consisting of securities representing a large part of the net worth of that company would, if accomplished, constitute a breach of duty owed to them as holders of Marriott's preferred stock. The transaction is to be voted upon by holders of common stock of the company at a forthcoming shareholders' meeting.[1]

According to the allegations of the amended complaint, plaintiffs are four institutional investors who between them have acquired more than 50% of Marriott's only presently issued class of preferred stock, the Series A Cumulative Convertible Preferred Stock. They bring this action seeking to enjoin the payment of the special dividend in question. Defendants include the corporation itself, and the ten individuals who serve as its board of directors. The board includes three members of the Marriott family, which together owns approximately 25.8% of the common stock of Marriott Corporation.[2]

The special dividend was originally announced on October 5, 1992. It engendered controversy. Bondholders of the company objected quickly and with feeling. The proposal has subsequently been modified to assuage some, but not all, of those bondholders. As presently planned, and speaking very generally, if accomplished the transaction will have the effect of splitting Marriott Corporation into two companies. The first of these will be a spin-off company, Marriott International, Inc., which will hold Marriott's lodging, food services and facilities management, and senior living services businesses.

The other will be the existing corporation, renamed Marriott Host Corporation, which will retain, either directly or through wholly owned subsidiaries, certain real estate, and airport, toll road, and stadium concessions, as well as certain other properties. These assets, allegedly, comprise approximately 33% of Marriott's equity. More importantly, however, Host will, directly and indirectly, retain responsibility for more than 85% of Marriott's long-term bond obligations, while International will assume only 15% of that liability.

---

1. The defendants are proceeding on the assumption that there is no legal requirement that the transaction that includes the special dividend be authorized by a shareholder vote. They nevertheless do intend to submit it to the Marriott common stock for approval.

2. All factual statements in this memorandum opinion are predicated upon the pleadings; they do not represent findings of fact.

This spin-off will be effectuated through the transfer of the spin-off assets to International (presently a wholly owned Marriott subsidiary), followed by a dividend to the holders of Marriott's common stock of all of the stock of International. It is alleged that in this spin-off most of Marriott's assets that generate a positive cash flow will be transferred to International. The value of the assets to be transferred has not yet been finally determined in the manner required by the certificate of designation that defines the rights, etc. of the Series A Preferred Stock. The time set for that valuation has not yet arrived.

The transaction will, of course, transform the capital structure of what is now Marriott with several important effects upon the preferred and common stockholders. Currently Marriott is obligated to pay annual dividends on the Series A Preferred Stock before it may pay any dividend on its common stock. It has regularly paid the preferred's dividend. On March 15, 1993, however, the company announced for the first time that, following the special dividend, Host will indefinitely suspend dividends on its preferred stock. (Am. Compl. ¶ 64).

Moreover, Marriott has announced that dividends of $.07 per share will be paid on the common stock of International, the same dividend as the common stock of Marriott currently earns. Thus, the transaction can be seen as enabling the common stockholders of Marriott to receive a dividend on their investment in Marriott without satisfying the requirement that the preferred stockholders receive their preferred dividends.

The financial situation of the preferred stock, as alleged, is complicated by the moves and countermoves of Marriott's bondhold ers. Since it is alleged that Host is to receive only 33% of Marriott's equity, but will retain 85% of its debt, the creditworthiness of Host will be significantly lower than that of the present Marriott. Bondholders felt aggrieved. Claiming that the dividend constituted a fraudulent conveyance and a breach of their indentures, certain bondholders filed suit against the company seeking to prevent the transaction from proceeding. On March 11, 1993, Marriott offered a settlement to certain of the bondholders which would provide greater protection of their interests.

The proposed settlement calls for the creation of a wholly owned subsidiary named "Holdings I," and a second corporation, a wholly owned subsidiary of Holdings I, named Holdings II. Host's most valuable and profitable assets: substantially all of its lodging properties, and substantially all of its airport, toll road, and other con-

cessions, are to be transferred to Holdings II. The Marriott bondholders will then exchange their bonds for new bonds ("Exchange Bonds") issued by Holdings II and guaranteed by Holdings I. The Indentures of the Exchange Bonds place significant restrictions on the ability of Holdings II to pay cash to Holdings I and Host. Therefore, Host's ability to use the cash generated by the most profitable assets with which it will be left will be greatly limited. Holdings I will have the right to borrow up to $630 million from International to pay the interest on the Exchange Bonds, and for other purposes, but not in order to pay dividends on the preferred stock.

Thus, since the time the complaint was filed on April 2, it has been the apparent expectation of all concerned that, if and when the proposed transaction is effectuated, no dividends will be paid by Host Marriott on any stock, but common stock dividends will be paid by International.

While after the special dividend transaction is completed, International and Host are planned to be treated as two separate corporate entities, International will retain certain relationships with Host. International will have substantial control over Host's operations. Holdings I will have the right under a credit agreement to borrow up to approximately $630 million from International for various purposes, including making payments to the subsidiary's bondholders. International will have long-term agreements to manage some of the hotel properties and other operations, such as retirement communities, retained by Host. International will have a right to share in the proceeds of some asset sales by Host and a right of first refusal in any sale by Host of its airport or toll road concessions. Also, for ten years after the distribution, International will have the right to purchase 20% of Host's stock if any person acquires 20% or if any person announces a tender offer for 30% or more of Host's stock. Finally, Host and International will at least initially share directors, as Richard Marriott will be Host's chairman and J.W. Marriott will be a director of Host while both are simultaneously serving as directors of International.

Thus, among other things, plaintiffs complain that the planned transaction constitutes a breach of the terms of the certificate of designation that defines the relative rights of the Series A Preferred Stock. Most notably, the proposed transaction will have the effect, it is said, of allowing the Marriott common stockholders to receive cash dividends while the preferred stock receives none, in contravention of a basic right of the preferred. The proposed transaction

is also said to constitute a breach of a fiduciary duty of loyalty and care and of the contractual obligations of good faith and fair dealing. Finally, plaintiffs contend that a public statement of October 1992 forms the basis of a fraud upon them and other holders of preferred stock.[3]

* * *

Upon filing the complaint, plaintiffs sought expedited treatment leading to a preliminary injunction hearing prior to the company's annual meeting then scheduled for June 1993. This application was granted and discovery was authorized to commence without delay. A time for the presentation of a preliminary injunction application was reserved for June 15. Defendants moved to dismiss the complaint and a time for presentation of that motion was reserved for May 10. That motion has now been submitted to the court, while discovery continues. This is my decision on certain aspects of the pending motion to dismiss the amended complaint.

I.

[1-2] The legal test that governs the disposition of a motion to dismiss is not controversial. If under any state of facts reasonably inferable from the facts that have been alleged plaintiff would be entitled to a judgment, then plaintiff should be accorded the right to discovery and present evidence in support of its claim. *Spence v. Funk*, Del. Supr., 396 A.2d 967, 968 (1978); *Klein v. Sunbeam Corp.*, Del. Supr., 94 A.2d 385, 391 (1952). The adverse is, of course, equally true. A dismissal is appropriate where the law recognizes the existence of no wrong even assuming all of the facts alleged can be proven and all inferences are drawn in plaintiffs' favor.

The Amended Complaint purports to set forth claims in three counts. The first Count purports to allege breach of fiduciary duty. The second purports to allege breaches of contract. The third purports to allege fraud.

---

3. According to the amended complaint, when the transaction was announced, representatives of Marriott were quoted in the press as assuring those with an interest:

> We intend to live up to our obligations, including payment of interest and principal when due. We firmly believe we have structured the transaction to achieve this objective by a comfortable margin. . . . Net cash flow of Host Marriott will be used primarily to service and retire debt. The company does not plan to pay dividends on its common stock.

(Am. Compl. ¶ 54).

In what follows I set forth my opinion that, with respect to the proposed special dividend, the rights of plaintiffs are contractual in nature and not equitable. That is, I conclude that with respect to this transaction, the directors of Marriott Corporation owe no duty of loyalty to holders of the preferred stock. For this reason I will dismiss Count I of the amended complaint as failing to state a claim upon which relief may be granted.

The corporation itself does undoubtedly owe a variety of duties to the preferred stockholders arising from the certificate of designation of rights, etc. which creates and delimits that property. Count II of the amended complaint alleges various breaches of this contract.

[3] Certain of plaintiffs' theories with respect to Count II would require the court to ignore the distinct corporate personality of International. The claim that plaintiffs have a class voting right, and the claim that their dividend preference will be violated by the payment of dividends to International common stock, appear to require the court to ignore the claim to legal personality that International can assert. *See* 8 *Del. C.* § 106 (1991). A court of equity will in certain instances ignore the legal fiction of corporate personality, but it seems quite settled that a Delaware court will do so only with great restraint. *See Pauley Petroleum v. Continental Oil Co.*, Del. Supr., 239 A.2d 629, 633 (1968); *Martin v. D.B. Martin Co.*, Del. Ch., 88 A.2d 612, 616 (1913); *Irwin & Leighton, Inc. v. W.M. Anderson Co.*, Del. Ch., 532 A.2d 983, 989 (1987).

The second theory advanced under Count II is to the effect that the proposed dividend violates the certificate because it forces rational holders of preferred stock to exercise their conversion right and thus destroys the contractual immunity from redemption, which exists under the certificate through 1995.

A third contractual theory advanced is that the financial terms of the transaction (i.e., their effect on the determination of the adjustment to the conversion price) will violate those provisions that are designed to afford to the preferred stockhold ers financial protection against dilution of their conversion right.

To defendants each of these theories is simply inconsistent with affording to the express language of the certificate its plain meaning and granting independent legal significance to Section 5(e)(iv) which appears to authorize a special dividend.

I am unable to address those portions of the pending motion to dismiss that are directed to Count II and Count III (misrepresenta tion/fraud) in the time that remains before presentation of the pre-

liminary injunction motion. The claims of Count I appear less rooted in factual complexity and more amenable to prompt resolution.

Therefore in an effort to simplify the forthcoming motion for preliminary injunction, I will make the incomplete ruling set forth below and retain jurisdiction over the remaining aspects of the motion to dismiss.

II.

I turn then to Count I which asserts that the directors of Marriott owe the holders of convertible preferred stock "fiduciary duties":

> to act only after receiving and considering all reasonably available material information, to act for their benefit, to exercise the highest standards of good faith and fair dealing, to act in a disinterested manner and to provide full disclosure of all material facts germane to any investment decision which Marriott calls upon shareholders to make.

Am. Compl. ¶ 69. Plaintiffs contend that each of these alleged duties are breached in the proposed transaction.

The core of the loyalty theory is the claim that the transaction is designed to benefit common stockholders at the expense of the holders of preferred. (*Id.* ¶ 70(a)(b)). Salt is added to the wound of the preferred, according to the complaint, because even bondholders will allegedly receive benefits from the deal (*id.* ¶ 70(c)(d)), but this fact has no direct legal significance to this theory of recovery in my opinion.

I assume for present purposes that plaintiffs can prove, insofar as the holders of preferred stock are concerned, that the proposed transaction is not "for their benefit" (*id.* ¶ 69) but is for the benefit of the common stock only.

Defendants say that Count I fails to state a claim upon which relief might be granted, because with respect to the proposed transaction, they owe no duty of loyalty to the preferred stock, no duty to act "for their benefit." Thus, they assert that proof of any such purpose or any "unfair" effect would not justify the imposition of liability on fiduciary duty grounds. In so contending defendants assert that with respect to this matter at least, the relationship between the preferred and the issuer is contractual and where the contract between them governs the matter, questions of liability will be determined by contract principles.

* * *

[4-5] Rights of preferred stock are primarily but not exclusively

contractual in nature. The special rights, limitations, etc. of preferred stock are created by the corporate charter or a certificate of designation which acts as an amendment to a certificate of incorporation. Thus, to a very large extent, to ask what are the rights of the preferred stock is to ask what are the rights and obligations created contractually by the certificate of designation. *See, e.g., Rothschild Int'l Corp. v. Liggett Group, Inc.*, Del. Supr., 474 A.2d 133, 136 (1984); *Ellingwood v. Wolf's Head Oil Ref. Co.*, Del. Supr., 38 A.2d 743, 747 (1944); *Shanghai Power Co. v. Delaware Trust Co.*, Del. Ch., 316 A.2d 589, 593 (1974). In most instances, given the nature of the acts alleged and the terms of the certificate, this contractual level of analysis will exhaust the judicial review of corporate action challenged as a wrong to preferred stock. *See, e.g., Judah v. Delaware Trust Co.*, Del. Supr., 401 A.2d 932 (1979).

[6-7] But the holder of preferred stock is not a creditor of the corporation. Such a holder has no legal right to annual payments of interest, as long term creditors will have, and most importantly has no maturity date with its prospect of capital repayment or remedies for default. In these respects the holder of preferred stock is in the exposed and vulnerable position, *vis-à-vis* the board of directors that all stockholders occupy. Thus, it has been recognized that directors may owe duties of loyalty and care to preferred stock. *See Porges v. Vadsco Sales Corp.*, Del. Ch., 32 A.2d 148 (1943); *MacFarlane v. North Am. Cement Corp.*, Del. Ch., 157 A. 396 (1928). For example, in a recent case a corporate board, elected by the common stock exclusively, negotiated and recommended to the common stock a cash merger (the preferred had been held to have no right to a class vote). Holders of preferred sued the directors asserting that the allocation of consideration between the common and the preferred was unfair. On a motion under Rule 23(e) to approve a proposed settlement it was held that, in the circumstances, the board had a burden to demonstrate that the apportionment of consideration that it negotiated and presented to the holders of common stock was not unfair to the preferred stock. *See In re FLS Holdings, Inc., Shareholders Litig.*, Del. Ch., No. 12,623, Allen, C. (Apr. 2, 1993).

[8] In fact, it is often not analytically helpful to ask the global question whether (or to assert that) the board of directors does or does not owe fiduciary duties of loyalty to the holders of preferred stock. The question (or the claim) may be too broad to be meaningful. In some instances (for example, when the question involves adequacy of disclosures to holders of preferred who have a right to vote) such a duty will exist. In others (for example, the declaration of a dividend

designed to eliminate the preferred's right to vote) a duty to act for the good of the preferred does not.[4] Thus, the question whether duties of loyalties are implicated by corporate action affecting preferred stock is a question that demands reference to the particularities of context to fashion a sound reply.

Of course even where a court concludes that contract principles govern the analysis, the need to address questions of ambiguity as to the scope of rights and duties under the certificate of designation may remain. The cognitive limitations of drafters, imperfect information and the nature of the language itself assure that in contract law as well as fiduciary law, good faith disagreements about the nature of duty will arise. Indeed the contract doctrine of an implied covenant of good faith and fair dealing may be thought in some ways to function analogously to the fiduciary concept.

* * *

For purposes of this motion to dismiss I accept as true the contention of plaintiffs that the Marriott directors were not in any respect motivated to advance the economic interests of the preferred stock in proposing this transaction to the common stockholders. Beyond that, of course, I accept as true all of the factual allegations of the amended complaint.

Nevertheless, given the terms of the certificate of designation I conclude that the proposed transaction does not implicate or engage the directors' duty of loyalty but must be evaluated under the contractual law governing the special rights and preferences of the preferred. Count I of the amended complaint will, therefore, be dismissed.

In explaining this conclusion it is only necessary to demonstrate that the tailored terms of the certificate, which define the nature of the property owned, govern the propriety of the proposed transaction. Most important, in this connection, is the fact that the certificate of designation expressly contemplates the payment of a special dividend of the type here involved and supplies a device to protect the preferred stockholders in the event such a dividend is paid. Section 5 of the certificate provides, in part, as follows:

> 5. *Conversion Rights*. The holders of shares of Convertible Preferred Stock shall have the right at their option, to

---

4. *E.g.*, Fletcher, *Corporate Law* § 5301 (1986). *Cf. Baron v. Allied Artists Picture Corp.*, Del. Ch., 337 A.2d 653, 660 (1976), *appeal dismissed*, 365 A.2d 136 (1976).

> convert such shares into shares of Common Stock on the following terms and conditions:
> (a) Shares of Convertible Preferred Stock shall be convertible at any time into fully paid and nonassessable shares of Common Stock at a conversion price of $17.40 per shares of Common Stock (the "Conversion Price").
>
> * * *
>
> (e) The Conversion Price shall be adjusted from time to time as follows:
> (iv) *In case the Corporation shall, by dividend* or otherwise, *distribute to all holders of its Common Stock . . . assets* (including securities . . .), *the Conversion Price shall be adjusted* so that the same shall equal the price determined by multiplying the Conversion Price in effect immediately prior to the close of business on the date fixed for the determination of stockholders entitled to receive such distribution by a fraction of which the numerator shall be the current market price per share (determined as provided in subsection (vi) below) of the Common Stock on the date fixed for such determination less the then fair market value (as determined by the Board of Directors, whose determination shall be conclusive and shall be described in a statement filed with the transfer agent for the Convertible Preferred Stock) of the portion of the evidences of indebtedness or assets so distributed applicable to one share of Common Stock and the denominator shall be such current market price per share of the Common Stock, such adjustment to become effective immediately prior to the opening of business on the day following the date fixed for the determination of stockholders entitled to receive such distribution. (emphasis added).

Thus, the legal obligation of the corporation to the Series A Preferred Stock upon the declaration and payment of an in-kind dividend of securities has been expressly treated and rights created. It is these contractual rights—chiefly the right to convert into common stock now or to gross-up the conversion ratio for future conversions—that the holders of preferred stock possess as protection against the dilution of their shares' economic value through a permissible dividend.

This conclusion reaches each aspect of the claimed fiduciary duty outlined in paragraph 69 quoted above.[5] Thus, in my opinion,

---

5. The amended complaint includes an allegation that defendants owed to

plaintiffs' first claim fails to state a claim upon which relief might be granted.

HB KORENVAES INVESTMENTS, L.P. v. MARRIOTT CORP.

No. 12,922

Court of Chancery of the State of Delaware, New Castle

July 1, 1993

Revised July 7, 1993

Plaintiffs, four institutional owners of preferred stock of defendant corporation, Marriott (Marriott), sought to enjoin a planned corporate reorganization. Marriott intended to separate its real estate business from its management and services businesses by creating a new corporate subsidiary, Marriott International (International). This "spin-off" would occur through a transfer of Marriott's management and services businesses to International and a distribution of the stock of International to Marriott common stock holders in the form of a special dividend. Claiming that the special dividend would deprive them of certain rights of their preferred stock, plaintiffs sought a preliminary injunction prohibiting the distribution and alleged the following: (1) that the transaction constituted coercive action designed to force them to exercise their conversion privilege and surrender their preference rights; (2) that the planned payment of dividends on International common stock, while suspending plaintiff's preferred dividend, violated the preferred stock's dividend preference; (3) that

---

plaintiffs and breached a duty of care. The pleading is to the effect that the board did not take care to protect the interests of the preferred sock in the transaction. As there is no claim that the transaction itself is injurious to the corporation, the due care argument is, in this instance, in fact another branch of a loyalty complaint: the transaction favors the common at the expense of the preferred (either because that is the intention or because the directors were insufficiently informed to do otherwise). In all events, for the reasons set forth in text, whether this transaction does *wrongfully* favor the common stock is a question of contract law.

the director's failure to allow preferred stockholders to vote on the "spin-off" violated plaintiff's voting rights; (4) that the special dividend violated certain provisions of the certificate of designation of the preferred stock; and (5) that Marriott committed fraud in the sale of the preferred stock.

The court of chancery, per Chancellor Allen, held that the plaintiffs failed to show a reasonable likelihood of success with respect to those aspects of their claims that stated a cause of action upon which relief could be granted. Therefore, the court refused to grant the preliminary injunction.

1. Injunction ⟹ 14, 132

The remedy of preliminary injunction is designed to prevent the occurrence of irreparable injury to plaintiff that threatens to occur before the merits of the claim can be heard and determined at trial.

2. Injunction ⟹ 1, 132

The remedy of preliminary injunction is a strong one as it entails a court exercising coercive judicial power before it has had an opportunity to hear all of the relevant evidence.

3. Injunction ⟹ 132, 135

The remedy of preliminary injunction is granted cautiously.

4. Injunction ⟹ 138.6, 138.15, 138.18

Where a plaintiff shows both a reasonable probability of success on the merits of the claim and the threat of irreparable injury and where the court concludes that granting the remedy threatens less harm to the defendant than denying it does to the plaintiff, the court will issue a preliminary injunction.

5. Corporations ⟹ 123(23)

Redemption and conversion are in all respects fundamentally different actions.

6. Corporations ⟹ 584

Any posited contractual right for preferred stock to be free from calls before a certain date plainly could not accomplish the following:

(1) create a veto right before that date over mergers that would convert the preferred stock to a right to receive cash; (2) create a veto right over a corporate dissolution; or (3) create a veto right over the declaration of dividends otherwise authorized.

7. Corporations ⟹ 62

In the preferred stock context, parties who contract with respect to one type of corporate right or action (e.g., redemption) will not be assumed to have intended their contract to affect another corporate right or activity (e.g., declaration of dividend) unless their contract cannot meaningfully be otherwise interpreted.

8. Injunction ⟹ 138.42

The court has on occasion enjoined as inequitable and inconsistent with an applicable fiduciary duty, corporate action designed principally to coerce stockholders in the exercise of a choice that the applicable certificate of incorporation, bylaws, or statute confers upon them.

9. Corporations ⟹ 310(2)

Injunction ⟹ 138.42

A gratuitous statement by the corporate directors concerning a plan to seek delisting of preferred stock constitutes an inappropriate effort to coerce acceptance of the corporation's offer.

10. Corporations ⟹ 62

Rights of preference are to be strictly construed.

11. Corporations ⟹ 62

While the strict construction perspective defines the court's approach to the construction and interpretation of the documents that create preferred stock, that principle does not excuse a court from the duty to interpret the legal meaning of the certificate of designation.

12. Corporations ⟹ 62

Where the necessary implication of the language used in the certificate of designation is the existence of a right or duty, a court

construing that language is duty bound to recognize the existence of that right or duty.

13. Fraud ⟹ 3

The elements of common law fraud are: (1) a false representation, usually one of fact, made by the defendant; (2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; (3) an intent to induce the plaintiff to act or refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance.

14. Fraud ⟹ 13(3)

In equity, defendants may be held responsible for damages caused by their false statements when they negligently or innocently believe the statements to be true.

R. Franklin Balotti, Esquire, Gregory V. Varallo, Esquire, and David L. Renauld, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and Ronald S. Rolfe, Esquire, of Cravath, Swaine & Moore, New York, New York, of counsel, for plaintiffs.

Michael D. Goldman, Esquire, and Stephen E. Norman, Esquire, of Potter Anderson & Corroon, Wilmington, Delaware; Arne M. Sorenson, Esquire, of Latham & Watkins, Washington, D.C., of counsel; and Frederic J. Zepp, Esquire, and Michael K. Hertz, Esquire, of Latham & Watkins, New York, New York, for defendants.

ALLEN, *Chancellor*

In this action holders of Series A Cumulative Convertible Preferred Stock of Marriott Corporation seek to enjoin a planned reorganization of the businesses owned by that corporation. The reorganization involves the creation of a new corporate subsidiary, Marriott International, Inc. ("International"), the transfer to International of the greatest part of Marriott's cash-generating businesses, followed by the distribution of the stock of International to all of the holders of Marriott common stock, as a special dividend.

Plaintiffs assert that the proposed special dividend would leave the residual Marriott endangered by a disproportionate debt burden and would deprive them of certain rights created by the certificate of designation that defines the special rights, etc., of the preferred stock. More particularly, they claim: (1) that the proposed transaction, taken together with a recently declared intention to discontinue the payment of dividends on the preferred stock, constitutes coercive action designed wrongfully to force them to exercise their conversion privilege and thus surrender their preference rights; (2) that the planned payment of cash dividends on International's common stock, while plaintiffs' preferred dividend will have been suspended, violates the preferred stock's dividend preference; (3) that the authorization by the directors of Marriott of the spin-off transaction, without the affirmative vote of the holders of preferred stock, violates the voting rights of the preferred conferred by the certificate of designation; and (4) that the distribution of the dividend will violate the provisions of Section 5(e)(iv) of the certificate of designation of the preferred stock. Section 5(e)(iv) is designed to protect the economic interests of the preferred stock in the event of a special dividend. Finally, plaintiffs allege (5) that defendants have made false statements upon which they have relied in buying preferred stock in the market and that defendants are liable for fraud.

The Series A Cumulative Convertible Preferred Stock is Marriott's only outstanding issue of preferred stock. Plaintiffs are four institutional investors who have acquired more than 50% of the preferred stock. They present their case as one involving manipulation, deception, and a legalistic interpretation of rights, which, if permitted and generalized, will impose a material future cost on the operation of capital markets.

Defendants assert that the reorganization, and more particularly the special dividend, constitutes a valid, good faith attempt to maximize the interests of Marriott's common stockholders. Marriott asserts the right to deal with the preferred stock at arm's length,[1] to afford them their legal rights arising from the certificate of designation, but also to take steps not inconsistent with those rights to maximize the economic position of Marriott's common stock. It

1. Plaintiffs contention that, with respect to this transaction Marriott owes to the holders of its preferred stock fiduciary duties was rejected and a claim based on the existence of such a duty has been dismissed. *See H.B. Korenvaes Invs., L.P. v. Marriott Corp.*, Del. Ch., No. 12,922, Allen, C. (June 9, 1993).

claims that this is what the proposed special dividend does. Defendants also deny that they have intentionally misled plaintiffs.

Pending is plaintiffs' motion for a preliminary injunction prohibiting the distribution of the special dividend. It is presently anticipated by defendants that the holders of Marriott's common stock will approve the proposed transaction at the company's annual meeting now scheduled for July 23, 1993, and that the distribution, if not enjoined, will occur in August or September of this year.

[1-4] The remedy of preliminary injunction is designed to prevent the occurrence of irreparable injury to plaintiff that threatens to occur before the merits of the claim can be heard and determined at trial. The remedy is a strong one as it entails a court exercising coercive judicial power before it has had an opportunity to hear all of the relevant evidence. Thus, it is granted cautiously. But where plaintiff shows both a reasonable probability of success on the merits of the claim and the threat of irreparable injury and where the court concludes that granting the remedy threatens less harm to defendant than denying it does to plaintiff, our court will issue a preliminary injunction. *Mills Acquisition Co. v. Macmillan, Inc.*, Del. Supr., 559 A.2d 1261 (1989); *AC Acquisition Corp. v. Anderson, Clayton & Co.*, Del. Ch., 519 A.2d 103 (1986); *Eisenberg v. Chicago Milwaukee Corp.*, Del. Ch., 537 A.2d 1051 (1987).

For the reasons that follow, I conclude that plaintiffs have not shown a reasonable likelihood of success with respect to those aspects of their claims that appear to state a claim upon which relief might be granted. *See infra* pp. 22-37. Certain theories plaintiffs advance do not appear to state such a claim and will be dismissed. *See infra* pp. 16-22.

I.

Except as otherwise indicated, I take the following background facts to be non-controversial.

(a) *The Company*

Marriott Corporation, as presently constituted, is in the business (1) of owning and operating hotels, resorts, and retirement homes; (2) of providing institutional food service and facilities management; and (3) of operating restaurants and food, beverage, and merchandise concessions at airports, tollway plazas, and other facilities. Its common stock has a present market value of approximately $2.6 billion. In December 1991, Marriott issued $200 million face amount of

convertible preferred stock bearing an 8 1/4% cumulative dividend, the stock owned by plaintiffs. Marriott has substantial debt, including Liquid Yield Option Notes ("LYONS") with an accreted value of $228 million;[2] and long-term debt of $2.732 billion. According to its proxy statement, the book value of Marriott's assets is $6.560 billion.

In the fiscal year ending January 1, 1993, Marriott's sales were $8.722 billion; earnings before interest, taxes, depreciation, and amortization (EBITDA) was $777 million; earnings before interest and corporate expenses was $496 million; and net income was $85 million. (Proxy Statement at 64). Each common share has received an annual cash dividend of $0.28 per share and the preferred stock dividends have been paid over its short life.

(b) *The terms of the preferred stock in brief*

The preferred stock is entitled to an 8 1/4% cumulative dividend and no more. It ranks prior to the common stock with respect to dividends and distribution of assets. It has in total, a face amount of $200 million and that, plus the amount of any unpaid cumulated dividends, "and no more" is the amount of its liquidation preference. The corporation may, at its option, redeem any or all of the preferred stock after January 15, 1996, at prices set forth in the certificate.

The preferred stock is convertible at the option of the holder into common stock at a conversion price set forth in the certificate. Generally that means that every $50.00 face amount share of preferred stock may be converted into 2.87 shares of common stock.[3] The certificate provides a mechanism to adjust the conversion price "in case the Corporation shall, by dividend . . . distribute to all holders of Common Stock . . . assets (including securities) . . . ." Certificate of Designation § 5(e)(iv).

The value of the right to convert is protected by a notice provision. The certificate provides that "in the event the Corporation shall declare a dividend . . . on its Common Stock payable otherwise than in cash or out of retained earnings," the corporation shall give

2. A leading finance text notes that "a liquid yield option (LYON) is a callable and retractable, convertible zero coupon bond (and you can't get much more complicated than that)." An example set forth in that text explains the security. *See* Richard A. Brealey & Stewart C. Myers, *Principles of Corporate Finance* 586 (3d ed. 1988).

3. *See infra* pp. 25-26.

written notice to the holders of the preferred stock fifteen days in advance of the record date. Certificate of Designation § 5(k).

There are no express restrictions on the payment of dividends other than the requirement that the quarterly dividend on the preferred must be paid prior to the distribution of dividend payments to common stock.[4]

(c) *Announcement of the proposed transaction*

On October 5, 1993, Marriott announced a radical rearrangement of the legal structure of the company's businesses. The restructuring was said to be designed to separate Marriott's "ownership of real estate . . . and other capital intensive businesses from its management and services businesses." (Proxy Statement at 19). The latter constitute Marriott's most profitable and fastest growing business segments. As indicated above, following this transfer Marriott intends to "spin-off" this new subsidiary by distributing all its stock as a dividend to Marriott's common stockholders.

(d) *Marriott International*

International is anticipated to be highly profitable from its inception and to be well positioned for future growth. It is expected to pay to its common stockholders the same dividend that has been paid to Marriott's common stock. Marriott's proxy statement describes International's proposed business activities as follows:

> Pursuant to existing long-term management, lease and franchise agreements with hotel owners, and [similar] agreements to be entered into with Host Marriott with respect to lodging facilities and senior living properties to be owned by Host Marriott, Marriott International will operate or franchise a total of 242 Marriott full service hotels, 207 Courtyard by Marriott hotels, 179 Residence Inns, 118 Fairfield Inns and 16 senior living communities. Marriott International will also conduct the Company's food and

4. *See* Richard M. Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 Calif. L. Rev. 243, 255-56 (1954) (review of possible protective provisions in preferred stock designation). *See also* Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 Bus. Law. 413, 424-26 (1986); William W. Bratton, Jr., *Corporate Debt Relationships*, 1989 Duke L.J. 92, 139-42 (1989) (both of which comment upon the "disappearance" in the last 20 years of dividend covenants in bond indentures).

> facilities management businesses, as well as the Company's vacation timesharing operations.

(Proxy Statement at xi).

According to its *pro forma* balance sheet for the quarter ending March 26, 1993, after the distribution (and assuming the Exchange Offer described below, *see infra* pp. 9-10, is effectuated) International will have assets of $3.048 billion, long-term debt of $902 million, and shareholders equity of $375 million. (Marriott Proxy Statement at 60).

Had International, with all the assets it will hold, been operated as a separate company in 1992, it would have had sales of $7.787 billion, earnings before interest and corporate expenses of $331 million, and net income of $136 million. (*Id.* at 62).[5] Marriott's adviser, S.G. Warburg & Company, has estimated that in 1993 International will have sales of $8.210 billion, and EBIT of $368 million.

(e) *Host Marriott*

Marriott's remaining assets will consist of large real estate holdings and Marriott's airport and tollway concession business. Marriott will be renamed Host Marriott ("Host"). The assets retained by Host have a value of several billion dollars but will be burdened with great debt and produce little cash-flow after debt service.

> Host Marriott will retain [ownership of] most of the Company's [Marriott's] existing real estate properties, including 136 lodging and senior living properties. Host Marriott will also complete the Company's existing real estate development projects and manage the Company's holdings of undeveloped real estate. Host Marriott will seek to maximize the cash flow from . . . its real estate holdings . . . . Host Marriott . . . will also be the leading operator of airport and toll-road food and merchandise concessions in the U.S., holding contracts at 68 major airports and operating concessions at nearly 100 toll-road units.

(Proxy Statement at xii).

Assuming the Exchange Offer (*see infra* pp. 9-10) is effectuated, after the special dividend Host will have, according to its *pro forma*

---

5. Note that this is a significantly higher net income figure than was reported by Marriott for FY 1992. *See supra* p. 4.

balance sheet as of March 26, 1993, assets of $3.796 billion, long-term debt of $2.130 billion and shareholders' equity of $516 million. (Marriott Proxy Statement at 70). Host's *pro forma* income statement for the fiscal year ending January 1, 1993, would reflect sales of $1.209 billion, earnings before corporate expenses and interest of $152 million, interest expense of $196 million, corporate expenses of $46 million, and a net loss of $44 million. (Proxy Statement at 72).

When he announced the spin-off transaction on October 5, 1992, Stephen Bollenbach, Marriott's chief financial officer stated, with respect to the future of Host:

> Net cash flow of Host Marriott will be used primarily to service and retire debt. The Company does not plan to pay dividends on its common stock . . . . I am very comfortable with the way Host Marriott has been structured. I believe this approach represents the best way for Marriott shareholders to unlock the value of our long-term assets. Secondly, the transaction gives Host Marriott the staying power needed if the recovery is slower than anticipated in arriving. I am convinced Host Marriott has the financial means to meet all its obligations to employees, suppliers, lenders and other stakeholders.[6]

Mr. Bollenbach reiterated this position two weeks later at a meeting of securities analysts.

(f) *Future operation of Host and International*

If the special dividend is distributed, International and Host will formally constitute two separate corporate entities. They will, however, share a large number of relationships. (Proxy Statement 34-47). International will have long-term agreements to manage many

---

6. Plaintiff has put forth substantial documentary support for their assertion that at the time this statement was made it was the expectation of the senior Marriott executives that the preferred stock dividend would not be paid following the distribution. This alleged undisclosed fact forms an important part of the predicate for their fraud claim in this lawsuit. Defendants deny that Marriott's responsible officers had at that time made the determination, which was later (March 15, 1993) announced, that preferred dividends would be discontinued. This factual dispute cannot be settled on this motion. For present purposes I assume that in October 1992 Marriott's responsible officers knew that no final decision on preferred dividends had been made, but expected such dividends to be discontinued; thus the lawyerly use of the term "obligation."

of Host's hotel properties and other real estate assets. International will have a right to share in the proceeds of some of Host's asset sales in lieu of receiving base management fees, as well as a right of first refusal in any sale of Host's airport and toll-road concessions. (*Id.* at 35).

As discussed below (p. 10), International will extend a $630 million line of credit to Host's subsidiary Host Marriott Hospitality, Inc. ("HMH"). (Proxy Statement at 43). For ten years after the special dividend, International will have the right to purchase 20% of Host's common stock if any person acquires more than 20% or announces a tender offer for 30% or more of Host's common stock. The two companies will have common management, as Richard Marriott will be Host's chairman and J.W. Marriott a director of Host, while both are simultaneously serving as directors of International. There will be a non-competition agreement between the two companies.

(g) *Bondholders' suits lead to modified transaction*

Despite Mr. Bollenbach's assurances of October 5, Marriott's bondholders reacted strongly against the proposed special dividend. The transaction will, of course, remove very substantial assets and even more cash flow from their debtor and will, in the circumstances, substantially increase the risk associated with the bondholders' investment, or so it was thought.

Ten class-action lawsuits seeking to block the dividend were filed by various classes of bondholders. They have been consolidated in the United States District Court for the District of Maryland.

On March 11, 1993, Marriott reached a settlement with the bondholder class action plaintiffs.[7] The settlement, if effectuated, would require Marriott to cause the Host subsidiary HMH to offer to exchange for existing bonds new bonds (Exchange Bonds) with a longer average maturity and bearing an interest rate 100 basis points higher than the existing bonds. The Exchange Bonds will include restrictive covenants that greatly limit opportunities for HMH to transfer cash to Host. Host's airport and toll road concession businesses, representing the preponderant part of its operating assets, and 40% of its cash-flow, will be transferred to a subsidiary of

7. Apparently one plaintiff, the PPM Group, has not agreed to participate in the settlement and its action would not be barred by the judgment or release proposed.

HMH. A $630 million credit line will be provided by International to HMH, but it cannot be drawn on to pay preferred dividends. One effect of the Exchange Offer, and the transfers it contemplates, is to restrict further Host's ability, as a practical manner, to pay dividends to the preferred stock.

Shortly after the Exchange Offer settlement, Marriott announced for the first time that it was intended that, following the special dividend, Host would not pay dividends on its preferred stock. On March 15, 1993, Host announced in an S.E.C. filing that:

> [i]t is the Company's present intention following the Distribution to declare dividends on its preferred stock only to the extent earnings equal or exceed the amount of such dividends. Since Host Marriott is expected to report book losses following the Distribution, this policy would lead to an indefinite suspension of dividends on the Company's preferred stock.

(Preliminary Proxy Statement: March 15, 1993; Final Proxy at 112).

(h) *Plaintiffs' acquisition of preferred stock and short sales of common*

Plaintiffs began for the first time to purchase substantial amounts of Marriott's preferred stock following the announcement of the special dividend.[8]

Since the preferred stock is convertible at the option of the holder into 2.87 shares of Marriott common stock and bears a dividend of 8 1/4% on its stated (liquidation) value of $50 per share, the market value of a share of preferred stock includes two possible components of value: the value of the conversion right and the value of the preferences. The presence of a presently exercisable conversion right will assure that the market value of the preferred will not fall

---

8. On October 7, 1992, plaintiff AKT purchased 140,500 preferred shares at prices ranging from $60.50 to $62.00. The next day AKT sold 14,000 preferred shares. AKT purchased an additional 50,000 shares on March 19, 1993, and 10,000 on March 29, 1993, after Marriott's March 15, 1993 announcement that Host would not pay dividends on the preferred. (Paugh Aff. Ex. C).

Plaintiff, Presidents and Fellows of Harvard College began purchasing preferred shares on October 30, 1992, and steadily accumulated shares for the next several months. Harvard held 480,300 preferred shares as of June 4, 1993, 83,000 of which were purchased after March 15, 1993. HB Korenvaes began a steady accumulation of preferred shares on October 6, 1992, and by June 4, 1993, held 408,000 preferred shares, 35,000 of which were purchased on March 17, 1993. Information of the dates of UBS Securities' purchases is not available.

below the market value of the security or property into which the preferred might convert, in this case 2.87 shares of common stock (less transaction costs of the conversion). The stated dividend, the dividend preference, the liquidation preference, and other features of the preferred will ordinarily assure that the preferred trades at some premium to the value of the conversion right.

In this instance plaintiffs have acquired a majority of the shares of the preferred stock. Plaintiffs, however, did not simply acquire preferred stock. The record shows that each of the plaintiffs, except one, have hedged their risk by entering short sales contracts with respect to Marriott common stock. In this way plaintiffs have isolated their risk to that part of the preferred stock trading value represented by that stock's preference rights. Any change in the market price of the preferred stock caused by movement in the value of the underlying common stock will in their case be offset by change in the extent of their obligations under the short sales contracts.

(i) *Marriott common and preferred stock price changes*

The prices of both Marriott common stock and Marriott preferred stock have increased substantially since the announcement of the special dividend. On the last trading day before the announcement of the transaction, Marriott's common stock closed at $17.125 per share. The day of the announcement the price increased to $19.25 and by June 4, 1993, it had reached $25.75, for a total increase of approximately 50.3%. (Paugh Aff. ¶¶ 6, 7).

The price of Marriott preferred stock closed on the last trading day before the announcement at $62.75, which represented a premium of $13.54 over the value of the 2.8736 common shares into which each preferred share could convert. The day of the announcement the preferred stock increased to $68.875. On June 4, 1993, the price of the preferred stock closed at $77.00 per share, an increase of 22.8% over the pre-announcement market price. The premium that the preferred stock commanded over the common into which it could convert (i.e., the market value of the preferences), however, had, by June 4th, shrunk to $3.00.

Thus, while both common stock and preferred stock have experienced substantial increases in the market value of their securities because of the impact of their hedging strategy, plaintiffs are in a different position than are non-hedged holders of preferred stock. The reduction of the premium at which the preferred stock trades

has resulted in losses on their short sales, leading some plaintiffs, as of June 4, 1993, to net unrealized losses on their investments.

For example, plaintiff, the president and fellows of Harvard College ("Harvard"), as of June 4, 1993, owned 480,300 shares of preferred stock, which were purchased for $33,580,108 and which had a market value on that day of $37,724,801. Thus, this plaintiff has an unrealized profit of $4,144,693 on its investment in the preferred stock. Harvard also entered into short sales of 1,338,300 shares of Marriott common stock, approximately 2.8 times the number of preferred shares it purchased. It received $30,949,383 on these short sales. The cost to cover these short sales, however, has increased to $34,609,056, or $3,659,673 more than was received on the sales, representing an unrealized loss in that amount. Thus, as of June 4, 1993, although the value of the preferred stock owned by this plaintiff has increased in value by over $4 million, the total value of its investment position has increased by only $485,020. (Paugh Aff. Ex. C).[9]

II.
Plaintiffs' Account

The foregoing set forth much of the factual background of the pending motion as it now appears. It does not set forth those contested facts that form an important part of plaintiffs' account of the case.

Plaintiffs take a dark view. They see themselves being forced by defendants to relinquish their preferences at a time when defendants cannot call or redeem their stock. This coercion is arranged for them, plaintiffs say, because the Marriott family is motivated to assure its continuing control over Host following the spin-off. That such a concern exists is evidenced by certain internal Marriott documents as well as by the existence of certain agreements that will give International the right to purchase 20% of Host's stock in the event that any person (as defined in S.E.C. Rule 13D) acquires 20%

9. At least two other plaintiffs have entered into similar transactions. AKT Associates L.P. had as of June 4, 1993, an unrealized profit on its preferred stock of $2,033,495 and increased cost to cover short sales of $2,036,777 for an unrealized loss of $3,282. (Paugh Aff. Ex. B). HB Korenvaes Investments, L.P. had an unrealized gain of $3,555,648 on its preferred and a loss of $3,793,089 on its short position for an unrealized loss of $237,441. (Paugh Aff. Ex. D). It is unknown whether plaintiff UBS Securities has entered into short sales of Marriott common stock. As of June 4, 1993, UBS had an unrealized gain of $10,668,505 on its 1,098,600 shares of preferred. (Paugh Aff. ¶ 14, Ex. E).

or announces a tender offer for 30% of Host's shares. (Proxy Statement at 119).

Working from the premise that control over Host is very important to the Marriott family, plaintiffs point out that after the special dividend (and after the adjustment of the preferred stock conversion rate that it will require) the preferred stock (if none of it is converted before the distribution) would be in a position to convert into more than 50% of the Host common stock. Thus, on this view, given the size of the special dividend, the existence of the conversion right transforms the preferred stock into a threat to Marriott family control of Host. The answer to this problem that plaintiffs say was hit upon was to force the preferred to convert into Marriott common stock before the record date for the special dividend. How could this be done? The principal means, according to plaintiffs, was to announce as early as the filing of Marriott's preliminary proxy on March 15, 1993, that Host would suspend dividends on the preferred stock indefinitely and would not reinstitute payment of the dividend until the company's "earnings equal or exceed the amount of such dividends." (Preliminary Proxy Statement March 15, 1993, at xiv; Final Proxy at 112).

The scheme that plaintiffs detect has other elements (some of which may constitute independent wrongs). For example, in order to make post-distribution conversion less attractive, plaintiffs assert that defendants are intending to deviate from the conversion rate adjustment formula in the certificate of designation.

Plaintiffs' theory has another, more Machiavellian aspect. According to plaintiffs, defendants knew in October 1992 that Host would not pay a dividend on its preferred stock, but withheld that information, and even implied the contrary in public statements (*see supra* p. 8). The first question that this assertion raises is the following: If knowledge of the discontinuation of dividends would promote the posited scheme to force conversions, why would defendants in October withhold knowledge of the planned suspension of dividends? This is where the plaintiffs' account gets Machiavellian. According to plaintiffs, defendants understood that institutional investors would move into the preferred stock following the October 5 announcement and that these investors would hedge their position by short-selling Marriott common. Investors in this position (who isolate their risk in the preference rights) are, it is said, particularly sensitive to the "coercive" effect of a suspension of dividends. Therefore, in delaying the announcement of the preferred dividend suspension, defendants

intended to cause these especially susceptible holders to move into the preferred stock before they sprang their trap.

III.
Plaintiffs' Legal Theories

Plaintiffs see the planned spin-off and the suspension of Marriott preferred stock dividends that is planned to follow it as constituting wrongs of several sorts.

First, they complain that the proposal violates a fiduciary duty running from the board of directors of Marriott to them as stockholders of the company. For the reasons expressed in an earlier opinion, I concluded, with respect to the spin-off transaction, that the Marriott directors owed no fiduciary duty to the holders of preferred stock. *See HB Korenvaes Invs., L.P. v. Marriott Corp.*, Del. Ch., No. 12,922, Allen, C. (June 9, 1993).

Secondly, plaintiffs assert that the proposed transaction and the suspension of dividends constitute multiple violations of the contractual rights of the preferred stock. The most plausible of these allegations is the claim that the special dividend violates the certificate of designation because it distributes such a large proportion of the value of Marriott that the certificate of designation provision designed to protect the economic value of the preferred, in the face of a special dividend, cannot work.

Lastly, plaintiffs assert that defendants have engaged in fraudulent conduct by making untrue statements upon which plaintiffs relied in acquiring Marriott preferred stock and that plaintiffs will be financially injured should the special dividend not be enjoined. Their injury, they say, will result from the loss of the value of the preferred stock premium over conversion value. That loss will irretrievably occur when they are coerced into converting. They will be coerced in this way, they assert, because neither they nor others can afford to own a preferred stock that pays no dividend. Therefore, unless an injunction is entered, defendants' scheme will be brought to a successful conclusion.

IV.
Probability of Success: The Certificate Claims

I turn first to an assessment of the probabilities of success of the claims asserted and, in that effort, set aside for the moment the fraud allegation in order to focus upon the breach of contract theories. As explained below, in my opinion, the heart of the matter is whether

the planned transaction is consistent with the intended functioning of the conversion price adjustment provision contained in the certificate of designation and quoted below. That subject is treated in part V. In this part plaintiffs' other breach of contract theories are addressed.

(a) The claim that the spin-off must be approved by the affirmative vote of 66 2/3% of the preferred stock because it creates a class of stock ranking prior to the preferred; and the claim that the planned payment of dividends to International common stockholders, while the Marriott preferred dividend is suspended, violates Sections 1 and 2 of the certificate of designation, both fail to state a claim upon which relief may be granted.

Section 1 of the certificate of designation provides that the preferred shall "rank prior to the Common Stock . . . with respect to the payment of dividends and the distribution of assets."

Section 2 restricts the ability of the company to pay dividends on its common stock. It provides in part: "Unless full cumulative dividends on all outstanding shares of the Convertible Preferred Stock shall have been paid . . . , no dividend shall be declared upon the Common Stock . . . nor shall any Common Stock . . . be redeemed, purchased or otherwise acquired . . . by the Corporation . . . ."

Section 6 of the certificate of designation provides that except as required by law, the preferred stock shall not have a vote, but, *inter alia*, the affirmative vote of 66 2/3% of all shares of preferred stock shall be necessary "to create, authorize or issue . . . any shares of any class of stock of the Corporation ranking prior to the Convertible Preferred Stock . . . ." The "Corporation" is defined as Marriott Corporation.

Plaintiffs claim that the special dividend violates Sections 1, 2, and 6 in that once it is effectuated Marriott would be enabled to pay dividends to its common stockholders without first paying the preferred dividend. In addition, the transaction would create, it is said, a security ranking prior to the common in terms of dividends, without a class vote of the preferred. In support of these assertions, plaintiffs expressly disclaim reliance upon the doctrine that permits a court of equity to ignore the formality of separate legal personality, to "pierce the corporate veil," where the corporate form is used to perpetrate a fraud or other inequitable conduct. *See Pauley Petroleum, Inc. v. Continental Oil Co.*, Del. Supr., 239 A.2d 629, 633 (1968); *Irwin & Leighton, Inc. v. W.M. Anderson Co.*, Del. Ch., 532 A.2d

983, 989 (1987). If, of course, one were able to say that the payment of dividends on the common stock of International would be payment of a dividend on common stock as defined in the certificate (i.e., Marriott's common stock), then a violation would be established. But this identity of legal entities is not urged.

Plaintiffs argue that the size of the special dividend and the close long-term relationships which will exist between Host and International after the special dividend,[10] demonstrate that the spin-off has no real purpose other than the avoidance of the rights of bondholders and preferred stockholders. Thus, plaintiffs assert that even accepting the separate legal identity of Host and International, the accomplishment of the planned special dividend would constitute a breach of Sections 1, 2, and 6 of the certificate. They rely upon a principle that courts will prevent contracting parties from evading their obligations by doing indirectly that which their contract forbids them to do directly and in support of this principle plaintiffs cite *Shenandoah Life Ins. Co. v. Valero Energy Corp.*, Del. Ch., C.A. No. 9032, Allen, C. (June 21, 1988).

Such a statement of principle is, in my opinion, too general to be meaningful. The relevant inquiry in contract cases often is what *is* the contractual obligation. Thus, certainly if a contractual duty is breached, it ought not to matter that the breach might be said to be the result of indirect action. But that principle does not assist in the identification of the duty owed.

The pertinent foundational inquiry here is whether there is a duty arising from the contract (the certificate) not to transfer substantial assets out of Marriott. The answer clearly is that there is no such duty. The certificate explicitly provides for such special dividends in Section 5. It is impossible to say that the payment of such a dividend is unauthorized. Does the large size of the planned distribution render it an evasion of the rights set forth in Sections 1, 2, or 6? Plainly, in my opinion, it does not. While, as set forth

---

10. Marriott's senior management team will continue as the senior management of International, International will have the same corporate headquarters as Marriott, pay the same $0.28 annual dividend on its common stock as Marriott pays, International will continue to manage the real estate owned by Host under 50 year management contracts, the two companies will share common board members, International has first refusal rights on Host's travel plaza business assets, and Host will be under a 10 year agreement not to compete with International. Plaintiffs argue that the economic reality of the situation is that International is Marriott without its obligations to pay interest and principal on its debt or dividends on its preferred stock.

below, the size of the distribution does create an issue under Section 5(e)(iv), if the dividend is consistent with the protections of the preferred *there* created, then plaintiffs will be afforded all of the protections to which they are entitled.

Only if the distribution of the dividend itself were unauthorized or a violation of the legal rights of plaintiffs could the argument plausibly be advanced that the property held by International after the distribution is equitably the property "of the Corporation," within the meaning of Sections 1, 2, and 6. But if that premise is established, plaintiffs will in all events be entitled to relief. If it is not established, then these theories are demonstrably flawed. Thus, it is the predicate fact—the invalidity of the distribution itself—that is legally meaningful. Unless that fact is established, it is perfectly obvious that the common stock of International is not stock "of the Corporation" (Section 6) and dividends paid on it are not paid on "Common Stock" (Sections 1 and 2) as defined in the certificate of designation (*See* certificate ¶ FIRST). Thus, I conclude that these theories fail to state a claim upon which relief can be granted.[11]

(b) Plaintiffs' claim that defendants are coercing conversion and thus in the process of violating the limitations on Marriott's redemption privilege fails to state a claim for violation of Section 4 of the certificate of designation.

Section 4 of the certificate affords to Marriott an option to redeem the preferred stock at stated prices, after January 15, 1996. The redemption price per share is stated as $52,480 in 1996 and decreases each year thereafter until it is at the stated (liquidation) value of $50,000 per share in the year 2002 and thereafter.[12]

Plaintiffs urge that they are being forced by defendants' suspension of the preferred stock dividend to convert into Marriott common stock and that Section 4 of the certificate grants them "call protection" until January 16, 1996. This aspect of Section 4, they say, constitutes a contractual undertaking by Marriott to permit

---

11. In my earlier opinion, decision on some aspect of defendants' motion to dismiss was reserved. *See supra* n.1.

12. Technically there are 4,000 shares of preferred stock outstanding. These shares do not trade but depositary shares representing 1/1000 of a share do trade and it is those interests that are owned by those who have invested in the preferred stock. Thus, throughout this opinion I have discussed the preferred stock in terms of the trading value and liquidation preference of these 1/1000th interests.

holders to enjoy the benefits of preferred stock ownership until that date. While plaintiffs concede that Marriott is not now redeeming the preferred stock, it is urged that its actions do violate an implied obligation not to interfere with plaintiffs' enjoyment of their preferred stock until that time. Plaintiffs see the suspension of the preferred dividend (most directly) and the size of the special dividend (less directly) as aimed at forcing them to give up those benefits prematurely.

[5] It is plain that an exercise of the conversion right, whether one accepts that it is "coerced" or not, does not constitute a redemption of that stock. The reasons for this are too obvious and fundamental to require much discussion. Legally, following conversion, holders of the preferred stock will remain shareholders of the corporation; were their stock redeemed, they would not. Moreover, economically, they will, in this instance, possess far greater value following conversion than the highest stated liquidation value. Redemption and conversion are in all respects fundamentally different actions. *Cf. Rothschild Int'l Corp. v. Liggett Group Inc.*, Del. Supr., 474 A.2d 133 (1984) (cash-out merger not a liquidation).

Plaintiffs say they accept that a coerced exercise of their conversion right is not a redemption but they say it does breach another duty contained in Section 4, a duty to respect their "call protection" until 1996. That is, they say the redemption right is a right that becomes exercisable in 1996. Before that time Marriott has no current right to redeem. As a logical consequence of this fact, plaintiffs claim that they have, prior to 1996, a correlative right of some sort (a "no call right") arising from Section 4 to remain as holders of preferred stock.

[6-7] I need not decide whether such a right exists. Assuming plaintiffs have such an interest, it is apparent that the special dividend or the suspension of preferred stock dividends would not violate it. Any posited contractual right to be free from calls for redemption prior to 1996 plainly could not, for example, create a veto right before that date over mergers that would convert the preferred stock to a right to receive cash;[13] or create a veto right over a corporate dissolution;[14] or the declaration of dividends otherwise authorized. In the preferred stock context, parties who contract with respect to one type of corporate right or action (e.g., redemption) will not be

13. *See, e.g.*, *Havender v. Federal United Corp.*, Del. Ch., 6 A.2d 618 (1939).
14. *Rothschild Int'l Corp. v. Liggett Group, Inc.*, Del. Supr., 474 A.2d 133 (1984).

assumed to have intended their contract to affect another corporate right or activity (e.g., declaration of dividend) unless their contract cannot meaningfully be otherwise interpreted. *See Waggoner v. Laster*, Del. Supr., 581 A.2d 1127 (1990). *See also infra* p. 27.

Thus, I conclude that Section 4 of the certificate of designation confers no rights upon plaintiffs that would be violated under the facts alleged in the amended complaint.

(c) Plaintiffs have shown no reasonable probability of prevailing on the claim that the announced suspension of the preferred stock dividends constitutes wrongful coercion regarding plaintiffs' conversion right.

A related claim is that the suspension of dividends constitutes wrongful coercion designed to force plaintiffs to convert to common stock. Plainly the discontinuation of current dividend payments on the preferred stock will tend to make conversion into Marriott common stock prior to the special dividend more attractive. Plaintiffs call the effect coercion and assert that in this context, it is a wrong. [8-9] This court has on occasion enjoined as inequitable and inconsistent with an applicable fiduciary duty, corporate action designed principally to coerce stockholders in the exercise of a choice that the applicable certificate of incorporation, bylaws, or statute confers upon them. *See, e.g., AC Acquisition Corp. v. Anderson, Clayton & Co.*, Del. Ch., 519 A.2d 103 (1986); *Lacos Land Co. v. Arden Group, Inc.*, Del. Ch., 517 A.2d 271 (1986); *Kahn v. U.S. Sugar Co.*, Del. Ch., No. 7313, Hartnett, V. C., *reprinted in* 11 Del. J. Corp. L. 908 (1986); *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051 (1987). These cases are premised upon the existence of a fiduciary duty on the part of the corporate directors with respect to the transaction under review. The last of them involved preferred stockholders to whom a tender offer had been extended by the Company. As an alternative holding this court held that a gratuitous statement by the Company concerning a plan to seek delisting of the preferred, constituted an inappropriate effort to coerce acceptance of the company's offer. *See Eisenberg*, 537 A.2d at 1062. Plaintiffs rely upon this precedent to argue that the announcement of the discontinuation of preferred stock dividends has an analogous effect and is analogously a breach of duty.

Plaintiffs are, I believe, incorrect in this. The critical differences between this case as it now appears and *Eisenberg* are several. First, that case was treated as a fiduciary duty case, not as a case involving,

as this one does, the construction and interpretation of rights and duties set forth in the certificate of designation. In this instance Marriott has a right to suspend dividend payments and in the event that that should happen, the preferred's protections are in the contract and are several: most importantly, the dividends are cumulative and enjoy a liquidation preference; in addition, the redemption price is adjusted to include unpaid dividends; and prolonged suspension of dividends gives the preferred the right to elect two directors. Finally, the preferred may, in all events, be converted into common stock; and, as I construe the certificate, there is necessarily implied a restriction on the proportion of net worth that may be distributed by special dividend. (*See infra* p. 27). These contractual protections are a recognition of the risk that dividends might not be paid currently. These protections are substantial. The correlative of the fact that Marriott has a duty to respect them is the conclusion that it has a right to discontinue dividends when it observes them.

Secondly, unlike *Eisenberg*, it cannot persuasively be urged, at this stage, that the discontinuation of dividends is not itself a prudent, business-driven decision. Thus, assuming that a corporation owes to the holders of its preferred stock the same implied duty of good faith that is present in every contractual relationship,[15] as I believe to be the case, the circumstances as they appear could not be construed as justifying the preliminary conclusion that the suspension of dividend payments is not a good faith business decision. Host is expected to have no net income, even though it will have substantial assets. Plaintiffs' suggestion that Host could, in the circumstances, borrow money to pay preferred dividends presents a classic business judgment issue; that such a possibility may exist does not constitute a persuasive

15. *See Gilbert v. El Paso Corp.*, Del. Supr., 575 A.2d 1131, 1143 (1990) (applying New Jersey law the court acknowledged that "an implied covenant of good faith and honest conduct exists in every contract"); *Merrill v. Crothall-American, Inc.*, Del. Supr., 606 A.2d 96, 101 (1992) ("At common law the duty of fair dealing and good faith was deemed impliedly to be a part of contracts of every kind."); *Blish v. Thompson Automatic Arms Corp.*, Del. Supr., 64 A.2d 581, 597 (1948); *Katz v. Oak Indus., Inc.*, Del. Ch., 508 A.2d 873 (1986); *Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R.*, 680 F.2d 933, 941 (3d Cir. 1982) (holding that failing to notify convertible debenture holders of a special dividend prior to the record date, thereby frustrating their right to participate in the distribution through conversion violated an "implied covenant that neither party will do anything which will destroy . . . the right of the other party to receive the fruits of the contract"); E. Allan Farnsworth, *Farnsworth on Contracts* § 7.17 (1990); *Restatement (Second) of Contracts* §205 (1981).

argument that the suspension of dividend payments was itself undertaken in bad faith.

Thus, while the suspension of dividends may exert a powerful influence upon the decision whether holders of preferred stock will exercise rights to convert or not, I can see in that effect, at this time, no violation of any implied right to that degree of good faith that every commercial contractor is entitled to expect from those with whom she contracts.

V.
The Section 5(e)(iv) Claim

I turn now to analysis of that which I regard as the centrally important certificate provision, Section 5(e)(iv). That section affords protection against dilution of the conversion component of the market value of the preferred stock by providing an adjustment to the conversion price when the corporation declares a dividend of assets, including securities. The principle that appears embedded in Section 5(e)(iv) is that when the assets of the firm are depleted through a special distribution to shareholders, the preferred will be protected by the triggering of a conversion price adjustment formula. Under Section 5(e)(iv) the number of shares into which the preferred can convert will be proportionately increased in order to maintain the value of the preferred's conversion feature. The principle seems clear enough; the realization of it will inevitably involve problems.

(a) Section 5(e)(iv) of the certificate of designation requires Marriott, when effectuating a special dividend, to leave sufficient net assets in the corporation to permit that Section to function as intended to protect the pre-disposition value of the preferred stock.

The language of the certificate of designation is as follows:

> 5. *Conversion Rights*. The holders of shares of Convertible Preferred Stock shall have the right at their option, to convert such shares into shares of Common Stock on the following terms and conditions:
> (a) Shares of Convertible Preferred Stock shall be convertible at any time into fully paid and nonassessable shares of Common Stock at a conversion price of $17.40 per share of Common Stock (the "Conversion Price").

* * *

(e) The Conversion Price shall be adjusted from time to time as follows:

(iv) *In case the Corporation shall, by dividend* or otherwise, *distribute to all holders of its Common Stock . . . assets* (including securities . . .), *the Conversion Price shall be adjusted* so that the same shall equal the price determined by multiplying the Conversion Price in effect immediately prior to the close of business on the date fixed for the determination of stockholders entitled to receive such distribution by a fraction of which the numerator shall be the current market price per share (determined as provided in subsection (vi) below) of the Common Stock on the date fixed for such determination less the then fair market value (as determined by the Board of Directors, whose determination shall be conclusive and shall be described in a statement filed with the transfer agent for the Convertible Preferred Stock) of the portion of the evidences of indebtedness or assets so distributed applicable to one share of Common Stock and the denominator shall be such current market price per share of the Common Stock, such adjustment to become effective immediately prior to the opening of business on the day following the date fixed for the determination of stockholders entitled to receive such distribution. (emphasis added).

Thus, stated simply, whenever Marriott distributes assets to its common stockholders this provision protects the value of the preferred conversion rights by reducing the conversion price. Protection of this type may be important to the buyer of preferred stock and presumably its inclusion will permit an issuer to arrange the sale of preferred stock on somewhat more advantageous terms than would otherwise be available. What is intuitively apparent is that in a narrow range of extreme cases, a dividend of property may be so large relative to the corporation's net worth, that following the distribution, the firm, while still solvent,[16] will not represent sufficient value to preserve the pre-dividend value of the preferred's conversion right.

---

16. Traditionally preferred stockholders have not been treated as creditors for the amount of the liquidation preference and the preference does not count as a "claim" for fraudulent conveyance purposes. *See Fletcher's Cyc. Corp.* § 5293 (perm. ed. 1986); *Compare Model Bus. Corp. Act* § 6.40(c)(2) (Supp. 1989).

Appended to this opinion are three hypothetical cases in which the Section 5(e)(iv) formula is employed. Case 1 involves a dividend of 40% of the issuing corporation's net asset value. Case 2 is a dividend of 90% of net asset value. Case 3 displays the consequences of a dividend of 95% of asset value. Given the assumptions of the examples (i.e., preferred conversion rights equal 9.1% of total pre-distribution value), only in the last case does the Section 5(e)(iv) formula fail to function.

In light of the mathematical effect demonstrated in the appended examples, a court that must construe Section 5(e)(iv) is required to conclude, in my opinion, that Marriott has voluntarily and effectively bound itself not to declare and distribute special dividends of a proportion that would deprive the preferred stockholders of the protection that that provision was intended to afford. In providing a mechanism to maintain pre-distribution value (putting to one side for the moment how pre-distribution value is determined), the issue impliedly but unmistakably and necessarily undertook to refrain from declaring a dividend so large that what is left in the corporation is itself worth less than the pre-distribution value of the preferred stock. No other interpretation of the certificate of designation gives the language of Section 5(e)(iv) its intended effect in all circumstances. Thus, were the facts of Case 3 the facts of this case, I would be required to find that the special dividend violated the rights of the preferred stockholders created by the certificate of designation.

[10-12] Such a holding would not be inconsistent with those cases that hold that rights of preference are to be strictly construed, e.g., *Waggoner v. Laster*, Del. Supr., 581 A.2d 1127, 1134 (1990); *Rothschild Int'l Corp. v. Liggett Group Inc.*, Del. Supr., 474 A.2d 133, 136 (1984); *Ellingwood v. Wolf's Head Oil Ref. Co.*, Del. Supr., 38 A.2d 743, 747 (1944). This strict construction perspective on the interpretation of certificates of designation has long been the law of this jurisdiction and others. While that principle does define the court's approach to construction and interpretation of the documents that create preferred stock, that principle does not excuse a court from the duty to interpret the legal meaning of the certificate of designation. *See Holland v. National Automotive Fibres*, Del. Ch., 194 A. 124, 126 (1937) (Wolcott, C.); *Garret v. Edge Morr Iron Co.*, Del. Ch., 194 A. 15 (1937), *aff'd sub nom. Pennsylvania Co. v. Cox*, Del. Supr., 199 A. 671, 673 (1938). Thus, where *the necessary implication* of the language used is the existence of a right or a duty, a court construing that language is duty bound to recognize the existence of that right or that duty. *See Sullivan Money*

Management, Inc. v. FLS Holdings, Inc., Del. Ch., No. 12,731, Jacobs, V.C. (Nov. 20, 1992), *aff'd*, Del. Supr., No. 545, 1992 (June 18, 1993).

(b) Plaintiffs have failed to introduce evidence from which it could be concluded at this time that it is reasonably probable that they will prevail on a claim that the special dividend violates Section 5(e)(iv).

(i) *The value that Section 5(e)(iv) intends to protect is the market value of the conversion feature at the time the board authorizes a special dividend transaction.*

The determination that Section 5 of the certificate creates by necessary implication an obligation on the part of the corporation to leave sufficient value in the corporation following a special dividend to permit the protections it creates to function with the intended effect, raises the further question, what value does Section 5 intend to protect. Plainly it is the value of the conversion feature, that is what all of Section 5 is about, but measured at what point in time?

On the last day of trading before the announcement of the special dividend, Marriott's common stock closed at $17.125. The preferred's *conversion feature* (its right to convert into 11,494,400 common shares) had a value at that time of $196,842,000. Beginning the first trading day after the announcement of the special dividend, Marriott common stock rose greatly in price. By May 21, 1993, it had increased to approximately $26.00 per share and the value of the preferred's conversion right had increased to $298.5 million. (Wright Aff. ¶ 18).

Plaintiffs' position is that this value, as effected by the prospect of the dividend attacked, is the value that must be left in the corporation.

I cannot accept this interpretation of what good faith adherence to the provisions of the certificate requires of Marriott. Section 5(e)(iv) operates to prevent the confiscation of the value of the preferred conversion right through a special dividend. By necessary implication, it limits the board's discretion with respect to the size of special dividends. But that limitation is one that has its effect when it is respected by the board of directors at the time it takes corporate action to declare the dividend.[17] If, when declared, the dividend will leave

17. I put aside, as not involved here, any attempt to affect market prices before taking such actions.

the corporation with sufficient assets to preserve the conversion value that the preferred possesses at that time, it satisfies the limitation that such a protective provision necessarily implies. That is, Section 5(e)(iv) does not, in my opinion, explicitly or by necessary implication grant the preferred a right to assurance that any increase in the value of their conversion rights following the authorization of a special dividend be maintained.

(ii) *Plaintiffs have failed to introduce evidence that establishes a reasonable probability of their proving that the net value remaining in Host after distribution of the special dividend is or is reasonably likely to be insufficient to maintain the pre- distribution value of the preferred's conversion right.*

In attempting to demonstrate that the special dividend will confiscate some part of their property, plaintiffs rely on the affidavit of Charles R. Wright, a certified public accountant. Mr. Wright states that following the special dividend the value of Host's equity will not exceed $200 million. (Wright Aff. ¶ 21). This opinion is based upon analyses conducted by Wolfensohn, Inc. in October 1992, concerning the transaction as planned at that time. But the transaction of October 1992 reflected a very different financial structure than that now planned; it contemplated Host bearing substantially more debt than the transaction currently envisioned.[18] (Wright Aff. ¶ 22). Mr. Wright's conclusions are also based upon analyses conducted by S.G. Warburg, but under the assumption that the Exchange Offer (*see supra* pp. 9-10) will *not* be effectuated. Mr. Wright stated that he did not consider later valuations of the transactions developed by Wolfensohn and S.G. Warburg to be relevant because they were based upon the assumption that the Exchange Offer would close, an assumption plaintiffs regard as unfounded. (Wright Aff. ¶ 22(d)). I do not accept this premise. For present purposes I assume that the Exchange Offer will close. It is an integral part of the complex transaction that is under review. Any part of that transaction could, in theory, be abandoned or modified. My analysis proceeds on the belief both that preliminary review on this application is nevertheless appropriate and that the transaction now planned is the transaction that forms the basis of that preliminary review.

18. The October 1992 Wolfensohn analysis, conducted while the transaction was in its planning stages, assumed that Host would have $2.98 billion in debt. Host is presently projected to have long-term debt of $2.494 billion if the Exchange Offer fails and $2.130 billion if it is completed.

The later projections by Wolfensohn and S.G. Warburg provide a different picture of Host's financial status than the earlier ones upon which Mr. Wright relies. On May 7, 1993, Wolfensohn provided Marriott's board with current valuations of Host and International. Wolfensohn concluded that, assuming the Exchange Offer closes, Host will have a total equity value of between $371 million and $556 million. (Lewy Dep. Ex. 16 at 3; Wolfensohn Valuation Summary May 7, 1993).

A discounted cash flow valuation of Host produced by Wolfensohn on April 20, 1993, and based on the assumption that the Exchange Offer will be effectuated, produced a range of values from $270 million (assuming a 14% discount rate and a multiple of 7 times EBITDA) to $884 million (assuming a 12% discount rate and a multiple of 9 times EBITDA) with a middle case of $567 million (assuming a 13% discount rate and a multiple of 8 times EBITDA). (Lewy Dep. Ex. 13 at 12; Wolfensohn Memorandum April 20, 1993).

S.G. Warburg's valuation of Host, dated May 6, 1993, estimated the trading value of Host, assuming the Exchange Offer closes, at $1.38 to $2.84 per share or an aggregate of $179 million to $368 million. Warburg also estimated that the summary business value of Host would be in the range of $551 to $830 million or $4.25 to $6.40 per share.

The lower end of S.G. Warburg's estimate of the likely range of trading values for Host stock falls below the $196.8 million that represents the value of plaintiffs' conversion rights prior to the announcement of the distribution. Unspecified assertions by plaintiffs' expert that "major assumptions used in the discounted cash flow analysis are inappropriate" and that companies used for comparison are not comparable to Host (Wright Aff. ¶ 22(c)) do not, however, provide a basis upon which to conclude that it is more likely that Host's common stock will have a value in the lower end of this range of values rather than in the higher part. The mere possibility that this will be the case is not enough to support the grant of a preliminary injunction. I assume the shape of a graph of the probability of any of these values in the range being "correct" would form a bell shaped curve. That is to say it is more likely that, upon more exhaustive analysis or with a more definite valuation technique, the intrinsic value of Host would be the mean number of these ranges rather than either expressed limit of them. These higher probability mean estimates are all in excess of $196 million.

Thus, I am unable to conclude that plaintiffs have shown a

sufficient probability of demonstrating that the protective functions of Section 5(e)(iv) will be frustrated by the size of the special dividend to justify the issuance of an injunction preventing the effectuation of the planned reorganization of Marriott.

(c) Plaintiffs have not shown that defendants have breached (or are about to breach) the agreed upon formula for implementing Section 5(e)(iv).

In its June 19, 1993 proxy statement, Marriott described the process that it intends to employ with respect to the operation of Section 5(e)(iv) of the certificate. After paraphrasing the certificate language quoted above (*see supra* pp. 25-26), the proxy statement states:

> The Board currently intends to determine the "fair market value" of the Distribution, for purposes of this calculation, by ascertaining the relative, intrinsic values of Host Marriott and Marriott International (with reference to all factors which it deems relevant) and by designating the allocable portion of the Current Market Price attributable to Marriott International as the fair market value of the Distribution.

In this litigation defendants have amplified their proposed method for determining fair market value of the individual distribution. Marriott intends to first determine "with reference to all relevant factors" the "intrinsic values" of International and Host. Then the fraction of the value of a Marriott share represented by International would be determined by dividing International's "intrinsic value" by the sum of the intrinsic values of International and Host. This fraction would then be multiplied by the current trading value of Marriott to determine the fair market value (per share) of International and thus of the distribution. Therefore, the fair market value of the distribution (i.e., International) is treated by the board's proposed valuation method *as fraction of the market value of Marriott prior to the distribution* of the dividend. (Def. Br. at 33). The premise of this methodology is the assertion that as long as Host common stock trades at some positive value, the fair market value of Interna tional for purposes of applying Section 5(e)(iv) must be less than the current market value of Marriott; the whole (Marriott) cannot be less than the sum of its parts (International plus Host).

Defendants claim that this method of determining fair market value is consistent with the certificate and that it reaches a determination

of the fair market value of the distribution that can meaningfully be compared to the current market value of Marriott. Indeed, they assert that any alternative technique which yields a value for International that is higher than the market value of Marriott must (as long as Host trades at a positive value) be faulty.

Plaintiffs contend that defendants' approach is inconsistent with the contract language. They say that it is designed to hide the fact that the special dividend is so large that the conversion price adjustment formula cannot work properly with respect to it.

Plaintiffs point out that the conversion price adjustment formula (*see supra* pp. 25-26) requires as a numerator the current per share market price of Marriott (determined over a thirty day period) less the "*then fair market value*" (expressed as a per share figure) of the assets distributed.[19] This number can be well estimated, it is claimed, by reference to the "when-issued" market which will, for a week or so before the distribution, establish a good proxy for the market value of the assets distributed.[20]

Plaintiffs claim that the method of determining the fair market value of International which defendants propose to employ is an attempt to manipulate Section 5(e)(iv), by artificially limiting the "fair market value" of the assets to be distributed (International's common stock) to a fraction of Marriott's total value despite the fact that Section 5(e)(iv) makes no mention of such a limitation. Plaintiffs rely on the language of the certificate which states explicitly that the board must determine the fair market value of the assets to be distributed, to support their argument that the board is required to determine this value without placing a ceiling on it of the value of Marriott.

---

19. I need not express a view as to whether the "then" is best read as (i) the time of the distribution (record date) or (ii) the time period during which the market value of Marriott stock is determined under the formula. In all events the "then fair market" is to be decided "by the Board of Directors, whose determination shall be conclusive," so long as made in good faith I would add.

20. Plaintiffs express the view that it is quite possible that the when-issued price for International will be in excess of the market price of Marriott, but if one is assuming contemporaneous measurement and one assumes Host will be solvent (which appears to be the case), it is difficult to see why that would be the case. Marriott common stock captures the full value of International before the distribution plus some additional value of a solvent Host. Thus, if Host is solvent it does seem illogical for a market to assign a higher value to International than to Marriott.

The possibility of different measuring periods (the certificate language contemplates that the current market value of Marriott be measured over a 30-day period commencing 45 days before the distribution) would introduce a possibility for the when-issued market for International to be higher on any particular day than the value of Marriott common stock over the measuring period.

* * *

In my opinion, Marriott's proposed technique for determining the values to employ in the contractual formula is one valid way to do what the company is contractually bound to do. It follows that this claim presents no grounds to justify the issuance of a preliminary injunction.

It is, of course, the case that plaintiffs' alternative technique might seem superior to some, in that it looks to a direct market measure of the value of the distribution. While that has appeal, it is also true that the different measuring times that this technique implies (*see supra* note 20) makes it possible that it would cause the adjustment formula to produce a negative number. Given the multiple factors that affect public securities markets, this could be true, even if far more equity were left in Host than the value of the preferred. Thus, there is good reason to reject plaintiffs' proposal even though it has appealing aspects.

Defendants' intended technique for estimating the "fair market value applicable to one share" would appear to serve the purpose of the section. As explained above, the equation is intended to operate to reduce the conversion price by the same percentage that the total assets of the company are being reduced. Assuming again that Host will have some positive net worth, it is clear that less than 100% of the assets of Marriott are being distributed. Therefore, in such a case the conversion price should be reduced by less than 100%. The method adopted by the company for determining applicable fair market value would, if fairly and competently applied, provide for the adjustment of the conversion price in a manner that effectuates the purposes of the clause. The certificate of course confers broad discretion on Marriott in implementing the formula of Section 5(e)(iv) and makes its choices "conclusive." While that grant may too imply a duty of commercial good faith, the facts adduced do not suggest that the employment of the formula by defendants has been other than in good faith.

Thus, I am unable to conclude that plaintiffs have shown a reasonable probability of success on the merits of their claim that the *method* of determining the fair market value of the assets to be distributed "applicable to one share of [Marriott] common stock," that defendants have announced they will employ, violates Section 5(e)(iv).

V I.

Plaintiffs Have Not Shown A Probability Of Success On The Merits Of Their Fraud Claim

Plaintiffs claim that Marriott intentionally misled them by making false statements in its October 5, 1992 announcement of the

special dividend transaction. In that announcement Mr. Bollenbach, Marriott's chief financial officer, stated that he was "convinced that Host Marriott has the financial means to meet all its obligations." Plaintiffs contend that memoranda written months before this announcement, and reviewed by Marriott's senior management, demonstrate that Marriott's managers were aware that Host would not be paying dividends upon its preferred stock.

[13-14] The elements of common law fraud are:

> 1) false representation, usually one of fact, made by the defendant; 2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; 3) an intent to induce the plaintiff to act or refrain from acting; 4) the plaintiff's action or inaction take in justifiable reliance upon the representation; and 5) damage to the plaintiff as a result of such reliance.

Gaffin v. Teledyne, Inc., Del. Supr., 611 A.2d 467, 472 (1992); *see also Harman v. Masoneilan Int'l, Inc.*, Del. Supr., 442 A.2d 487 (1982). In equity, however, defendants may be held responsible for damages caused by their false statements when they negligently or innocently believe the statements to be true. *Stephenson v. Capano Dev., Inc.*, Del. Supr., 462 A.2d 1069, 1074 (1982).

Assuming for purposes of this motion that defendants deliberately (or in all events actionably) failed in October to disclose a settled decision to suspend the preferred stock dividend, plaintiffs have nevertheless failed to show a reasonable likelihood of success upon the merits of their fraud claim. They have failed to make a sufficient showing that they will be able to prove several other essential elements of this claim.

Plaintiffs have failed to show a reasonable likelihood that defendants intended to induce plaintiffs to take any action in response to their representations. To establish this element plaintiffs propound a theory that defendants made the October statements in an effort to entice institutional holders such as plaintiffs to purchase the preferred stock, because defendants

[start - revised page - July 7, 1993]

believed these type of investors would be easily forced to convert into common stock when the dividend was finally "pulled." There is very little record evidence to support this theory. In fact, the best reading of the record is that defendants had very little interest in

who owned the preferred stock but were primarily concerned with placating the bondholders.

Plaintiffs have also failed to show a likelihood that they will be able to prove that they in fact relied on defendants' statements in making their purchases of preferred. Plaintiffs AKT Associates, Harvard College, and HB Korenvaes all continued to purchase preferred stock *after* the March 15, 1993 announcement that no dividend would be paid. (Paugh Aff. Exs. B-D). While this fact clearly does not preclude plaintiffs from maintaining that they relied on the earlier statements that all obligations would be met, it does raise an inference that plaintiffs were not relying on promises that the dividend would be paid in making their earlier purchases.

Finally, plaintiffs have not shown a likelihood that they will be able to prove "actual" as opposed to nominal damages. The market price of plaintiffs' shares has increased substantially since the announcement of this transaction. Even if plaintiffs succeed in proving the other elements of their fraud claim, they will still face substantial difficulty in proving that they have suffered actual economic losses, not because these losses may be difficult to measure (that state of affairs would weigh in favor of a conclusion that no adequate remedy at law exists), but because a strong case for their existence has not yet been shown.

In light of the weaknesses of plaintiffs' claim, I cannot conclude that they have shown a likelihood of success on the merits. Therefore, this claim cannot support the grant of the requested injunctive relief.

[end - revised page - July 7, 1993]

* * *

Defendants may present an implementing form of order upon notice.

APPENDIX

The following three hypotheticals demonstrate how Section 5(e)(iv) operates to preserve the economic value of the conversion rights of the preferred when the company's assets are distributed as dividends to the common stockholders, and how at extreme levels it could fail.

CASE I

Assume a company, Corporation Y, with $1 billion in assets

and no debts. It has 10 million shares of common stock and 1 million shares of cumulative convertible preferred stock having a face amount and liquidation preference of $100 million. The preferred is convertible into common stock at a price of $100 face amount per common share or into 1 million common shares, in total. The certificate of designation contains a provision identical to Section 5(e)(iv).

Assume further that the capital markets operate efficiently and the common stock trades at a price reflecting Corporation Y's asset values on a fully diluted basis.

Under these assumptions at Time T_1, Current Market Price ("CMP") is determined as follows:

$$\text{CMP} = \$1 \text{ billion} \times \frac{1}{11 \text{ million shares}} = \$90.9091 \text{ per share}$$

$$\text{Preferred Conversion Value} = 1 \text{ million shares} \times \frac{\$90.9091}{1 \text{ share}} = \$90{,}909{,}100$$

At time T_2 Corporation Y declares a dividend of assets with a fair market value of $400 million or $40 per outstanding common share, leaving the company with $600 million in assets.

The conversion price would be adjusted by the same formula as applies in Section 5(e)(iv):

$$\text{ACP} = \text{CP} \times \frac{\text{CMP} - \text{FMV}}{\text{CMP}}$$

Where:

ACP = Adjusted Conversion Price
CP = Conversion Price
FMV = Fair Market Value
CMP = Current Market Price common stock

$$\text{ACP} = 100 \times \frac{\$90.9091 - \$40}{\$90.9091} = \$56.0000$$

The preferred would become convertible into 1,785,710 common shares,

$$\$100,000,000 \times \frac{1 \text{ common share}}{\$56.0000} = 1,785,870 \text{ common shares}$$

with an aggregate value of $90,908,900,

$$\$600,000,000 \times \frac{1,785,710 \text{ converted shares}}{11,785,710 \text{ common shares}} = \$90,908,900$$

Thus, in this case, the anti-dilution provision of the certificate would serve to preserve the economic value of the preferred stock despite the diversion of 40% of Corporation Y's net worth out of the company.

CASE II

Now assume alternatively that Corporation Y declares a special dividend to its common stockholders of $900 million of its assets or $90 per outstanding share.

The conversion price adjustment formula would work to adjust the conversion price from $100 to $1 per share:

$$\text{ACP} = \$100 \times \frac{\$90.9091 - \$90}{\$90.9091} = \$1.0000$$

The preferred would become convertible into 100,000,000 shares, (91% of all common stock) at T_2.

$$\$100,000,000 \times \frac{1 \text{ common share}}{\$1.0000} = 100,000,000 \text{ shares}$$

But the aggregate value of the preferred portion would remain unchanged at $90,909,091:

$$\frac{100{,}000{,}000 \text{ converted shares}}{110{,}000{,}000 \text{ common shares}} \times \$100{,}000{,}000 = \$90{,}909{,}091$$

Thus, on these assumptions, even if 90% of Corporation Y's assets are distributed to the common stockholders, the conversion value of the preferred is maintained at its pre-distribution level by the Section 5(e)(iv) gross-up provision.

CASE III

When the special dividend is so large that insufficient equity remains in Corporation Y to maintain the value of the preferred, upon conversion the gross-up provisions will fail to work.[1] In such a situation the gross-up equation provides for a negative adjusted conversion price and is, therefore, meaningless.

For example: If Corporation Y declared a dividend of $950 million of its assets, the gross-up equation would give the following result:

$$ACP = CP \times \frac{CMP - FMV}{CMP}$$

$$ACP = \$100 \times \frac{\$90.9091 - \$95.00}{\$90.9091} = -(\$4.499)$$

Thus, a distribution of $950 million leaves only $50 million in assets in the corporation, making it impossible for the preferred to maintain its pre-distribution conversion value of $90.909 million. For that reason it also causes Section 5(e)(iv) to fail to work meaningfully.

1. They may also fail, in the specific case of Section 5(e)(iv) because the measurement period for "current market price" is somewhat historical while the measurement period for "fair market value" of assets distributed is current. Thus, it may happen, given the potentials for fluctuating market prices, for a negative number to be generated simply as an artifact of the formula. *See supra* note 20.

KAHN v. LYNCH COMMUNICATION SYSTEMS, INC.

No. 8748

Court of Chancery of the State of Delaware, New Castle

July 9, 1993

Plaintiff brought a class action against defendant Alcatel USA Corporation for breach of fiduciary duty in connection with its acquisition of Lynch Communications Systems, Inc. Plaintiff claimed that Alcatel exercised control over Lynch as a minority stockholder and ultimately acquired Lynch at an unfairly low price through the use of a misleading tender offer circular. Defendant Alcatel claimed that, as a minority shareholder, it had no fiduciary duties to Lynch, and Alcatel further asserted that the transaction was fair.

The court of chancery, per Vice-Chancellor Berger, held that, even though Alcatel was a minority shareholder, it exercised control over Lynch's business decisions at a board meeting on August 1, 1986. However, the court found that Alcatel did not control the terms or the approval of the ultimate merger between Alcatel and Lynch, finding instead that the transaction had been carried out at arm's length and that there was no compulsion to reach an agreement. Finally, the court found that the offering circular distributed by Alcatel was sufficient in disclosing all material information within its control at the time of distribution. Thus, the court found that, although Alcatel was a fiduciary of Lynch, Alcatel did not breach its duty; therefore, the court entered judgment for defendants.

1. Corporations ⟹101

A minority shareholder that exercises control over the business affairs of a corporation is accountable as a fiduciary.

2. Corporations ⟹101

Evidence that a minority shareholder exerted control over the business affairs of a corporation does not necessitate a finding that the shareholder controlled all of the corporation's business affairs.