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Recent Delaware Corporate Cases

Preferred Stock and Stockholders

A. *Benihana of Tokyo, Inc v. Benihana, Inc.*:[1] Plaintiffs seeking rescission of the issuance of preferred stock with preemptive rights, sought to invalidate the stock claiming, *inter alia*, that such rights were prohibited in the company's certificate of incorporation. The Court denied Plaintiffs' claims for relief.

- While the certificate included blank check authorization, it also set forth that "no stockholder shall have any preemptive right…"[2] The Court found that this text was boilerplate language intended to prevent the assumption of preemptive rights under the common law, rather than to prohibit the company from specifically granting preemptive rights by contract.

B. *Matthews v. Groove Networks, Inc. et al.*:[3] Plaintiffs claimed that proceeds from a merger where the company was acquired should not be included in a liquidation preference owed to preferred stockholders. The Court rejected this claim and granted the Defendants' motion for summary judgment.

- The certificate of incorporation granted the preferred stockholders a preference as a result of the occurrence of a liquidation event (including a merger). The preference was to be paid from "Distributable Assets", the definition of which did not specifically mention merger proceeds. Because the liquidation preference was to be paid out in the event of a merger, it made "little sense" to pay the preference only out of the assets of the corporation – those assets would be transferred to the merged entity.

C. *Shintom Co., Ltd. v. Audiovox Corp*:[4] The Delaware Supreme Court affirmed dismissal of a claim that preferred stock was void for lack of dividend rights, holding that "it is legally possible for an otherwise bona fide preferred stock of a Delaware corporation to have no right to receive dividends under *any* circumstance."

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1 2005 Del. Ch. LEXIS 191 (Dec. 8, 2005).
2 *Id.* at *49.
3 2005 Del. Ch. LEXIS 201 (Dec. 8, 2005).
4 888 A.2d 225 (Del. 2005).

Business Combinations

A. *Ubiquitel Inc. v. Sprint Corp.*:[5] Ubiquitel sought damages for tortious interference against Sprint-Nextel because, as a result of the merger announced between Sprint and Nextel, Sprint canceled Ubiquitel's license to be the sole provider of Sprint PCS cell phone service in certain states. The Court, applying Pennsylvania law, denied Sprint's 12(b)(6) motion.

- As a pleading requirement, Ubiquitel only needed to allege that Nextel knew an injury was substantially certain to result from the merger. Nextel knew the merger would cause a breach of the license agreement, because the companies stated so in their joint proxy statements.
- Nextel argued that it could not be liable for tortious interference because, in order for the breach to occur Sprint and Nextel would have to have merged, and a party cannot tortiously interfere with its own contract. The Court rejected this argument, because the merger announcement may have been an anticipatory repudiation of the contract. Ubiquitel's claim was bolstered by a requirement, under the license contract, that Ubiquitel provide Sprint with a great deal of confidential information that may have been shared with Nextel in preparation for the merger.

B. *Abry Partners V, L.P. v. F&W Acquisitions LLC*:[6] Buyer in the sale of a corporation sought to rescind the Stock Purchase Agreement ("SPA") based on false statements contained within the agreement. The seller moved to dismiss, for failure to state a claim, based on a provision in the SPA that limited the seller's liability for misstatements to the extent of the fund established to pay such damages. The Court held that, to the extent that there was no intentional deception on the part of the seller, the buyer's damages were restricted to the damages fund. Intentional "lies" by the seller, however, would be not be protected by contract.

- The Court rejected the view of the Restatement (Second) of Contracts § 195, that reckless misrepresentation should not be protected by contract.

Takeover Defenses

UniSuper Ltd. v. News Corporation:[7] Stockholders of News Corporation (the "Company") sought to invalidate the extension of a poison pill, claiming that extending the pill without a stockholder vote was in breach of an agreement that it entered into with the Company's board of directors. The stockholder action included five counts: (1) breach of contract; (2) promissory estoppel; (3) fraud; (4) negligent misrepresentation; and (5) breach of fiduciary duties. Defendants moved to dismiss the action under Rule 12(b)(6). The Court refused to grant the motion to dismiss as to the claims for breach of

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[5] 2005 Del. Ch. LEXIS 198 (Dec. 19, 2005), *summary judgment denied*, 2006 Del. Ch. LEXIS 2 (Jan. 4, 2006) (Also dismissing without prejudice unripe claims based on the grant of a Federal Communications License to NEXTEL in the bandwidth included in the Ubiquitel License).

[6] 891 A.2d 1032 (Del. Ch. 2006).

[7] 2005 Del. Ch. LEXIS 205 (Dec. 20, 2005), *interloc. appeal certification granted*, 2006 Del. Ch. LEXIS 11 (Jan. 20, 2006), *and interloc. appeal denied*, 2006 Del. LEXIS 85 (Jan. 27, 2006).

contract and promissory estoppel, but dismissed the claims for fraud, negligent misrepresentation, and breach of fiduciary duty.

- The Company decided to domesticate from an Australian corporation to a Delaware corporation. Institutional shareholders of the Company were in a position to prevent the conversion, if they voted to do so. To gain the support of those shareholders, there was to be a board policy established that a stockholder vote would be required to renew a poison pill one year after the Company put a pill into effect ("Board Policy").
- Shortly after the vote approving the conversion, and in response to a possible hostile takeover, the Company had reason to put a poison pill into effect. In the announcement of the pill, the Company stated that it may not implement the Board Policy.
- The directors moved to dismiss the contract claim for two reasons. First, the claim did not adequately allege a contract. Second, any contract would be unenforceable under § 141(a) of the Delaware General Corporation Law ("DGCL"), which requires such a grant of authority to be set forth in the Company's certificate of incorporation.
- The Court reasoned that all agreements limit the board's options in management of the firm to some extent, because they agree to do something. Section 141(a) only means that directors cannot grant a significant power of management to an outside group. The Court stressed the distinction that the power to veto the poison pill was given to the shareholders, rather than an outside group.[8]
- The Court further made a distinction by describing Section 141 in terms of agency law. The board's power "derives from the shareholders, who are the ultimate holders of power under Delaware law."[9]
- The Court also stated that fiduciary duties cannot be used offensively to "silence" the wishes of the stockholders.[10]
- Claims for fraud, negligent misrepresentation, and breach of fiduciary duties were dismissed for failure to meet pleading requirements.

Attorneys Fees

A. *In re Instinet Group, Inc. Shareholders Litigation*:[11] Plaintiffs' counsel applied for $1.45 million in fees and approximately $173,000 in costs following the settlement of a class action suit. The Defendants disputed the amount of fees requested. The Court awarded only $450,000 in fees and expenses, finding that the settlement was "modest" and did not "correlate with the claim asserted", and that the settlement was reached at an early stage of litigation.

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8 The Court noted that it might have been "troubling" if the agreement put the decision in the hands of a less than a full vote of all stockholders. *Id.* at *26.

9 *Id.* at *25. In a later opinion considering the Defendants' motion for certification of an interlocutory appeal, the Court clarified that the analogy to "agency law principles [illustrated] why the nature and purpose of fiduciary duties [was] to serve as a shield for shareholders, not as a sword for directors." *UniSuper Ltd. v News Corporation*, 2006 Del. Ch. LEXIS 11 at * 11 (Jan. 20, 2006).

10 *Id.* at *32.

11 2005 Del. Ch. LEXIS 195 (Dec. 14, 2005).

Indemnification/Advancement

A. *Paul S. Levy, et al. v. Hayes Lemmerz International, Inc., et al.*: [12] The directors of Hayes Lemmerz ("Hayes") sought an order requiring Hayes, both before bankruptcy ("Old Company"), and after the emergence from bankruptcy (the "New Company") to indemnify them for their settlement expenses in connection with class action litigation arising from the Old Company's restatement of financials. The defendants moved to dismiss for failure to state a claim. Defendants contended that all counts against the New Company should be dismissed because the plaintiffs were never directors of the New Company. Defendants also moved to dismiss the complaint against both the Old and New Company because allegedly plaintiffs had breached their indemnification agreements.

- The Court dismissed the plaintiffs' indemnification claims as to the New Company, finding that the New Company had no obligation to indemnify its predecessor's former directors and officers. The outside directors never were directors of the New Company, and never signed indemnification agreements with the New Company.
- The Court denied the motion to dismiss as to the Old Company. The claims against the Old Company pursuant to the plaintiffs' indemnification agreements were authorized by the Old Company's bylaws. The Court also found that the indemnification agreements did not require written demand for indemnification.
- The defendants also claimed that the Court should stay the plaintiffs' indemnification action until the SEC concluded the investigation into the accounting irregularities and financial restatements, but the Court rejected their argument.

B. *Orloff v. Shulman*:[13] Minority stockholders in a closely held business claimed oppression, corporate waste, violations of the duty of loyalty, and false disclosures against majority stockholders/directors, including that the directors amended the by-laws and certificate of the company in anticipation of litigation to protect themselves from any personal liability arising from Plaintiff's claims. The Court dismissed the claim relating to the by-laws because there was no showing that the advancement provision was unreasonable. The Court dismissed the claim relating to the amended certificate because the complaint failed to allege particularized facts impugning the directors independence.

Stockholder Agreements

Dweck v. Nassar:[14] Plaintiff sought appointment of a custodian under DGCL § 226, claiming breach of an unsigned stockholder agreement, and violation of the duty of loyalty relating to her termination and the Defendant's installation of his allegedly unqualified nephew to run the business. Defendants moved for judgment on the

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[12] 2006 Del. Ch. LEXIS 68 (April 5, 2006).
[13] 2005 Del. Ch. LEXIS 184 (Nov. 23, 2005).
[14] 2005 Del. Ch. LEXIS 183 (Nov. 3, 2005).

pleadings. The Court dismissed all claims except for claims alleging a breach of the duty of loyalty relating to the hiring of the nephew, because under DGCL § 228, voting agreements are required to be signed. Because there was no valid agreement, the board nominated by the controlling shareholder was not deadlocked, so there was no reason to grant a custodian under DGCL § 226. Claims regarding the nephew survived, because there was a material issue of fact as to his qualifications.

Information Demands

A. *Kaufman v. Computer Associates International, Inc.*:[15] Plaintiff requested books and records under DGCL § 220. Defendants, the special litigation committee ("SLC") for the company, moved to stay the document request pending derivative litigation proceeding in another jurisdiction. The Court denied the motion to stay.

- Although the Plaintiff was not party to the derivative litigation, the Defendants argued that allowing the Plaintiff to proceed would remove the power of the SLC to control the litigation. The Court held that a § 220 information request exists independently from other claims the Plaintiff might bring, and is not affected by related litigation.
- After finding that the information request would not burden the SLC, the Court denied the request to stay.

B. *Seinfeld v. Verizon Communications Inc.*:[16] Plaintiff sought information relating to the compensation of co-chief executives under DGCL § 220. The Court denied the information request as lacking a proper purpose. The Plaintiff challenged, as waste and mismanagement, the amount of compensation and that incentive contracts were amended after the hiring of these executives. The Plaintiff, however, did not challenge the process by which the decisions to grant compensation were made, only the judgment of the board and its committees. There was no credible basis for the Court to infer wrongdoing.

Internal Affairs Doctrine

Newcastle Partners, L.P. v. Vesta Insurance Group, Inc.:[17] Plaintiffs shareholders sought and obtained an order compelling an annual meeting under DGCL § 211. The Defendants sought relief from the order, because financial disclosures required by the federal securities laws for the meeting were not ready to be distributed. In denying the Defendants' motion, the Court noted that the legislative history of the federal requirements did not indicate an intent to interfere with the power of state courts to require stockholder meetings. The Court further noted that there was no conflict between the state and federal requirements as both were aimed at preserving stockholder voting rights. The Court also noted that the decision was aligned with the policy of the internal affairs doctrine that the internal governance of a corporation is dictated by its state of incorporation.

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[15] 2005 Del. Ch. LEXIS 192 (Dec. 13, 2005).

[16] 2005 Del. Ch. LEXIS 185 (Nov. 23, 2005).

[17] 887 A.2d 975 (Del. Ch. 2005), *aff'd*, 2005 Del. LEXIS 463 (Nov. 16, 2005).

Merger – Entire Fairness and Business Judgment Rule

A. *Crescent/Mach I Partnership, L.P. v. Turner*:[18] Former stockholders in a merged corporation claimed that the directors failed in their *Revlon* duties to get the best price for the company. In considering the Defendants' motion for summary judgment, the Court granted summary judgment as to some claims and denied the motion as to others.

- Without more, a fiduciary of an acquired corporation who takes employment with the surviving entity does not need to demonstrate the fairness of their compensation package with the surviving entity – the motion to dismiss this claim was granted.
- The Court denied the motion as to the claim that the director had intentionally deflated merger projections in order to reduce the merger price, because it raised a material issue of fact. Although the issue was central to a separate appraisal action, this fact was not enough to have the claim dismissed in this context.
- Claims for loss of corporate opportunity against a separate company formed by the director were derivative in nature, and as a result of the merger the Plaintiffs no longer had standing to assert them.
- Claims against the acquiring company were dismissed because there was no evidence that the acquiring company had *knowingly* abetted any breach of fiduciary duties.

B. *In re Tele-communications, Inc. Shareholders Litigation*:[19] In a class action suit against directors for breach of fiduciary duties relating to a merger, the directors moved for summary judgment. The Court granted the motion as to all claims except for claims of disclosure violations and entire fairness.

- There was an issue of fact raised by "contingent, ambiguous, or otherwise uncertain" compensation for the committee approving the merger as to whether the compensation created a conflict for the directors, or whether disclosure of the compensation would be material to stockholders.
- The ratification by the committee did not shift the burden back to the Plaintiffs in the entire fairness analysis, because the independence of the committee was a material fact.
- The Court found that alleged process flaws in the operation of the committee such as the lack of a clear mandate, selection of directors, and selection of conflicted advisors, prevented the claims from being dismissed at this stage in the litigation.
- Finally, the Court found that a material question of fact existed as to whether a 10% premium paid to a class of stock held by directors was fair to the other stockholders.

C. *In re LNR Property Corp. Shareholders Litigation*:[20] Plaintiffs in a purported class challenged the fairness of a cash-out merger. Defendants moved to dismiss for failure to

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18 2005 Del. Ch. LEXIS 209 (Dec. 23, 2005).

19 2005 Del. Ch. LEXIS 206 (Dec. 21, 2005 revised Jan. 10, 2006).

20 2005 Del. Ch. LEXIS 171 (Nov. 4, 2005; revised Dec. 14, 2005).

state a claim, asserting the business judgment rule as the standard for review. The Court denied the motion to dismiss based on the facts alleged in the complaint – the transaction would probably be reviewed under the entire fairness standard.

- The controlling stockholder was alleged to stand on both sides of the transaction because he had a 20% interest in the acquiring entity.
- The Court distinguished *Orman v. Cullman* because there the independent committee negotiated the deal, and the merger agreement contained a majority of the minority voting condition; here the committee only approved the deal, and minority stockholder approval was not required.

D. *Gentile v. Rossette*:[21] Plaintiffs, stockholders of a software company that had never generated any revenue, challenged as inadequate the conversion rate in a conversion of debt to stock, and claimed a breach of the duty of loyalty relating to additional consideration the controlling stockholder received in the merger. Defendants moved for summary judgment based on the assertion that the claims were derivative in nature and the Plaintiffs lost standing to bring them after the merger. The Court granted the motion as to the dilution claim but denied the motion as to the additional consideration claim.

- The issuance of shares in the conversion was a derivative claim because the dilution was a direct injury to the company, as its stock was being issued below its value.
- The additional consideration granted to a director and controlling stockholder in the merger agreement was a direct claim if it resulted in an unfair price. The consideration implicated the director's duty of loyalty, because he received value for his stock that was not shared by other stockholders.
- Ratification by the board was insufficient because the board consisted of two persons, and therefore a majority was not disinterested. Ratification by a majority of the minority stockholders was tainted by the alleged incomplete disclosure of the additional consideration.
- Thus, the claims on the merger could not be dismissed on summary judgment.

Breach of Fiduciary Duties and Corporate Waste

A. *Canadian Commercial Workers Industry Pension Plan v. Eric Alden, et al. and Case Financial, Inc.*:[22] Plaintiff asserted a derivative action against the former directors of Case Financial (the "Company"), which included claims for breach of the duty of loyalty and corporate waste, breach of the duty of oversight (a "*Caremark* claim"), and common law fraud. One of the two directors which remained in the case, Alden, had previously entered into an agreement with the Company which released him except for conduct constituting a crime under California or Federal law ("Crime Exception"). Both directors moved to dismiss.

- With respect to Alden, the Court rejected the motion to dismiss as to the fraud and loyalty claims, finding that the allegations fell within the Crime Exception, but dismissed the duty of oversight claims based on the release.

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[21] 2005 Del. Ch. LEXIS 186 (Nov. 21, 2005).

[22] 2006 Del. Ch. LEXIS 42 (Feb. 22, 2006).

- The Court also found that Plaintiff failed to state a *Caremark* claim, and so dismissed such claim as to Alden and the other director defendant, Bibicoff.
- Bibicoff's motion to dismiss the fraud claim for lack of personal jurisdiction, as well as the directors' motion to dismiss on the grounds of inadequate derivative plaintiff and improper delegation were also denied.

B. *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, et al.*:[23] The selling parent of a subsidiary, KB Toys, was the holder of a $45 million note issued in connection with the sale and the largest unsecured creditor in the bankruptcy proceeding involving the subsidiary. It brought an action arising from the sale and subsequent refinancing asserting breach of fiduciary duty, fraud, and civil conspiracy claims against among others, defendant Glazer, the manager and an executive of KB Toys and a director of the plaintiff.

- The Court concluded that most of the plaintiff's claims were barred because they were derivative employing the *Tooley*[24] analysis, and thus belonged to the bankruptcy estate. The Court dismissed the Counts (III – V, VII and IX) alleging fraud and fiduciary duty breaches, noting "fundamental differences" between this case and the circumstances in *Production Resources*[25], relied on plaintiff in arguing its claims were direct, where "all the challenged transactions arose in the context of an already insolvent company."[26]
- The Court dismissed Count II, which involved a claim of fraudulent inducement, on the alternative ground that it failed to state a claim.
- The other counts asserted by plaintiff, a fraud claim in connection with the purchase agreement for KB Toys, and a claim against Glazer in his capacity as a director of Plaintiff, were also dismissed for failing to state a claim.

C. *Highland Legacy Limited v. Steven G. Singer, et al. and Motient Corporation*:[27] A substantial stockholder of Motient (the "Company") brought a derivative action alleging that the directors committed corporate waste by paying exorbitant fees and warrants to two financial advisory firms. The plaintiff also alleged that the directors breached their fiduciary duties by allowing the brother of one of the directors to serve as a director in violation of a federal court order that prevented him from serving as an officer or director of a public company. The defendants moved to dismiss under Rule 23.1 for failure to establish demand futility.

- The Court dismissed the claims for failure to establish demand futility, as there were insufficient allegations that a majority of the board was controlled by or financially beholden to defendant Singer, the Company's Chairman. Plaintiff had alleged that two of the directors, Goldsmith and Steele, were dominated by Singer because they served together on the boards of unaffiliated companies. The Court found such allegations insufficient for purposes of the first prong of the *Aronson* Rule 23.1 test.

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[23] 2006 Del. Ch. LEXIS 59 (March 28, 2006).
[24] *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004).
[25] *Production Resources Group v. NCT Group*, 863 A.2d 772 (Del. Ch. 2004).
[26] *Id.* at *28.
[27] 2006 Del. Ch. LEXIS 55 (March 17, 2006).

- The Court also found that plaintiff failed to satisfy the second prong of *Aronson* -- there were insufficient allegations to create a reasonable doubt that the transactions were not a valid exercise of the board's business judgment, either by failing to comply with procedural due care or sufficiently alleging corporate waste.

D. *Horbal, et al. v. Three Rivers Holdings, Inc., et al.*:[28] Plaintiff, a founder of an HMO, but forced out by his co-investors ("Co-Investors"), alleged that the Co-Investors abused their management positions by "siphoning off tens of millions of dollars from the HMO in the form of disguised salaries, bonuses and corporate perquisites", which plaintiffs characterized as "*de facto* dividends".[29] Plaintiffs alleged breaches of the defendants' fiduciary duties, and also alleged they were improperly denied their right to books and records under Section 220.

- Plaintiffs' *de facto* dividends claim was based on allegations of self-dealing. Plaintiffs sought to have the Court treat the alleged wrongful payments as "*de facto* dividends" to which they had a right to share in equally. The Court responded that "[n]o Delaware Court has ever recast executive compensation as a constructive dividend,"[30] or recognized such a cause of action. The Court dismissed the *de facto* dividend claim with prejudice.
- Plaintiffs' other claims were viewed as classic self-dealing or waste claims, and because plaintiffs had not adequately pled a duty of loyalty claim, the Court dismissed, without prejudice, plaintiffs' claim for breach of fiduciary duty.
- The Court, however, found that Plaintiffs were improperly denied their right to books and records under Section 220.

E. *G. William Carlson, et al v. Charles Hallinan et al*:[31] This action arose out of a dispute between one of the plaintiffs, Carlson, who controlled 30% of the stock of CR Services ("CR"), and one of the defendants, Hallinan, who controlled 65% of CR's stock and served as its chairman. Plaintiffs asserted direct claims for breach of contract, derivative claims for breach of fiduciary duty and aiding and abetting, and claims for attorneys' fees for both a prior, related action and this action.

- After trial, the Court found that Hallinan breached an oral contract with plaintiffs, that he and the other individual defendant, Gordon, a director, Vice President and the other stockholder of CR, committed breaches of their fiduciary duties to CR, and that certain corporate defendants aided and abetted certain breaches of fiduciary duty.
- Hallinan and Gordon bore the burden of establishing the entire fairness of their salaries and a challenged management fee. The director defendants argued that because they, as majority stockholders, ratified the challenged transactions, the burden shifted to Plaintiffs to prove that the transactions were not entirely fair. The Court noted that stockholder ratification must be by a majority of

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28 2006 Del. Ch. LEXIS 53 (March 10, 2006).
29 *Id.* at *1.
30 *Id.* at *10
31 2006 Del. Ch. LEXIS 58 (March 21, 2006).

disinterested and fully informed stockholders. In this case, the shares voted to ratify Hallinan and Gordon's actions were held by Hallinan and Gordon.

- Hallinan and Gordon also failed to show that any of the payments to themselves as compensation were the product of fair dealing. The Court thus concluded that Hallinan and Gordon failed to satisfy the requirement of entire fairness to CR and therefore they breached their fiduciary duties to CR by paying themselves the challenged compensation.
- Hallinan and Gordon also failed to demonstrate that the management fee was the result of a fair process and thus the Court concluded that the management fee was not entirely fair to CR.
- As to the wrongful payment of indemnification and advancement monies to themselves, the Court found that Hallinan and Gordon never considered an undertaking and that the nondecision was not afforded the protection of the business judgment rule and did not satisfy the requirements of Section 145. Therefore, the Court concluded that CR's payment of Hallinan and Gordon's expenses for the defense of this action was *ultra vires*.
- The Court further found that certain corporate defendants controlled by Hallinan and Gordon were liable to CR for aiding and abetting.
- Plaintiffs were also found to be entitled to their attorneys' fees for the Section 220 action. Plaintiffs established that Hallinan and Gordon acted in subjective bad faith in refusing Plaintiffs' inspection demand -- their attempt to remove Carlson as a director of CR two days after he requested documents from CR amounted to bad faith.
- Finally, the Court held that CR should be dissolved and a receiver appointed to wind up its affairs. The Court stated that "the facts and circumstances here, however, comprise the very rare case where the appointment of a receiver and the dissolution of a solvent corporation is necessary… Without the appointment of a receiver to wind up CR's affairs, the Court concludes that Hallinan and Gordon will continue to breach the duties they owe CR and thus cause further harm to the corporation and Plaintiffs".[32]

Arbitration

Travelers Insurance Co. v. Nationwide Mutual Insurance Co.:[33] The Court vacated an award by an arbitration panel. Although arbitration decisions are not usually reviewed on their merits, this decision warranted reversal because the Court held that the panel's decision had manifestly disregarded the law. The Court defined "manifest disregard" as an error of law that "would instantly be perceived" by an ordinary arbitrator. Here, the law states that subrogated rights shall be limited to the tortfeasor's liability insurance. The arbitrator awarded insurance damages after the insurer had settled with the victim at the limits of the coverage, a decision the court held was "plainly wrong".

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32 *Id.* at *97.

33 886 A.2d 46 (Del. Ch. 2005).

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