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Review of Selected 2007 Chancery and Supreme Court Cases

By Francis G.X. Pileggi

Special to the DLW

This is the third year that I have provided a brief overview of selected key corporate and commercial decisions from the Delaware Court of Chancery and the Delaware Supreme Court based on summaries of those same decisions that I have posted on my blog.

I have not included some of the well-known cases that have already been extensively discussed in widely read publications. Rather, my purpose is to briefly refer to key decisions that would interest most business litigation practitioners and provide them with the means to access readily the entire decision that covers a particular issue. By using the search function on my blog and entering the case name, one can find a link to download the entire opinion for each case listed.

Delaware Supreme Court

Alaska Electrical Pension Fund v. Brown, et al., (Del. Supr., Dec. 21, 2007). The Delaware Supreme Court decided in this opinion, on appeal from the Chancery Court, that an out-of-state litigant could be awarded attorney fees and expenses in connection with a settlement of a

Delaware corporate class action. The appellant had filed a class action in California, alleging substantially the same claims as those alleged in the Delaware action. The Delaware plaintiffs agreed to settle their claims after they had negotiated a \$7 per share increase in the disputed

Review continues on page 4

Review

Continued from page 1

transaction. Appellant did not agree to settle at that price, and the price later increased another \$9 per share. The Supreme Court remanded to the Chancery Court for it to determine what amount, if any, of fees should be awarded due to the second price increase.

In *Appriva Shareholder Litigation Company, LLC v. EV3 Inc., et al.*, (Del. Supr., Nov. 1, 2007), the Delaware Supreme Court determined that: (i) it was reversible error for the trial court to convert a motion to dismiss under Rule 12(b)(6) into a Rule 56 Motion for summary judgment without providing an opportunity to present pertinent evidentiary material.

Moreover, the court ruled that it was error for the trial court, *sua sponte*, to convert a motion to dismiss under Rule 12(b)(6) into a Rule 56 motion for summary judgment without affording the parties adequate notice or a reasonable opportunity to respond as required by Rule 56; (ii) in addition, the court determined that it was reversible error to choose between two differing interpretations of ambiguous documents, in a motion to dismiss; (iii) finally, under Rule 17, the Supreme Court determined that the parties should have an opportunity to cure any defects regarding the named defendants in light of the purpose of Rule 17 which is to "prevent forfeiture when determination of the proper party to sue is difficult or when an understandable mistake has been made."

In *Mahani v. EDIX Media Group Inc.*, (Del. Supr., Sept. 4, 2007), the Delaware Supreme Court ruled that when the basis for awarding attorney fees was contractual as opposed to statutory, the "reasonableness of attorneys' fees and other expenses in a contractual fee shifting case should be assessed by reference to legal services purchased by those fees, not by reference to the degree of success achieved in the litigation."

The court determined that the Chancery Court correctly concluded that the amount involved in the litigation and the results

FRANCIS G.X. PILEGGI, ESQUIRE, is the founding partner of the Wilmington office of Fox Rothschild, an AmLaw 200 firm. His blog at www.delawarelitigation.com summarizes all the key decisions on corporate and commercial law from the Delaware Court of Chancery and Delaware Supreme Court. His e-mail address is fpileggi@foxrothschild.com.

obtained were only two of the factors to be considered.

The Delaware Supreme Court, in a short order, affirmed last year's Chancery Court decision that sounded the death knell in Delaware for a cause of action called deepening insolvency (and doubted the special status given to the concept known as the "zone of insolvency"). See *Trenwick America Litigation Trust v. Ernst & Young, LLP*, 2006 WL 2333201 (Del. Ch. 2006).

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In *North American Catholic Educational Programming Foundation Inc. v. Gbewehalla*, (Del. Supr., May 18, 2007), the Delaware Supreme Court upheld the Chancery Court's determination that creditors of a Delaware company do not have a direct claim against directors of an insolvent corporation or one in the so-called zone of insolvency.

In *Gatz v. Ponsoldt*, (Del. Supr., April 16, 2007), the Delaware Supreme Court held that the basis for the claims presented was not exclusively derivative, and therefore, could be brought directly. (Many cases in this summary are of court opinions that are upward of 50 or more pages, so the point here is to highlight the issues addressed by the court instead of a thorough treatment of each case.)

This is an unusual case where the Supreme Court reversed the Chancery Court. The Chancery Court held that because the sham transaction did not itself cause any harm to plaintiffs and that the harm that the plaintiffs sought to remedy flowed from the terms of the recapitalization at issue, the remedy would be to unwind the recapitalization and return to the corporation some or all of the funds that were allegedly distributed due to recapitalization. The Supreme Court reasoned differently.

Chancery Court

In *United Rentals Inc., v. RAM Holdings Inc.*, (Del. Ch., Dec. 21, 2007), the Chancery Court rejected a claim for specific performance against Cerberus in a 68-page opinion that is destined to be a seminal decision on issues of contract interpretation and contract drafting.

Among other things, this opinion shows how quickly the Chancery Court, in appropriate circumstances, can schedule a trial and issue a decision involving hundreds of millions of dollars within a few short weeks of the complaint being filed. The complaint in this case was filed, and discovery and a trial took place, as well as a summary judgment motion disposed of, and a final post-trial decision issued, all in about 30 days.

In *Fogel v. U.S. Energy Systems Inc.*, 2007 WL 4438978 (Del. Ch., Dec. 13, 2007), the Chancery Court addressed issues raised in connection with a contested board meeting during which the chief executive officer was allegedly fired. After the purported firing, the CEO attempted to call a shareholders' meeting. The board refused to hold the shareholders' meeting because they said the CEO who called it was no longer in office.

The court held that the board meeting at which the board attempted to fire the CEO was not convened properly and thus the termination was "legally void," however, the *Blasius* standard was not a problem. Board meetings held without proper notice and those where a member's attendance is procured by deceit, are not properly convened.

In *Sample v. Morgan*, 2007 WL 4207790 (Del. Ch., Nov. 27, 2007), the Chancery Court determined that a non-Delaware lawyer in a non-Delaware law firm who provided advice on Delaware law to a Delaware corporation and who caused documents to be filed with the Delaware secretary of state, are both subject to personal jurisdiction in Delaware courts.

In a prior decision in this case earlier in the year, the court described in detail the lawyer's role in the actions of the board that the court determined to be problematic. See *Sample v. Morgan*, 2007 WL 177856 (Del. Ch., Jan. 23, 2007), where the court chided directors for being mere "unwitting and uninformed accomplices" in a plan to enrich other directors. The court rejected the argument that shareholder ratification had "cleansed" the transactions, and much of the reasoning

Review continues on page 5

Review

Continued from page 4

relied on by the court was based on the following principle: "Every corporate action must be twice-tested: first, by the technical rules having to do with the existence and the proper exercise of power; second, by equitable rules applicable to fiduciaries." See my short article on the Chancery's first decision in the Feb. 21, 2007, edition of *The Delaware Law Weekly*.

In *Melzer v. CNET Networks Inc.*, 2007 WL 4146237 (Del. Ch., Nov. 21, 2007), the Chancery Court determined that a shareholder was entitled to books and records for a period of time prior to the date of stock ownership in order to allow for the detail necessary to plead a sustained and systemic failure of oversight by the board as described in the *Caremark* case.

West Willow-Bay Court LLC v. Robino Bay Court Plaza LLC, 2007 WL 3317551 (Del. Ch., Nov. 2, 2007). This case upheld the bedrock principle of Delaware contract law that the court will uphold agreements entered into by sophisticated parties according to their terms and will not modify them or admit extrinsic evidence to interpret them when the agreement is clear, notwithstanding hardship or burdensomeness that may have accrued with time and which may have been avoided in hindsight.

The court also noted that the parties will be bound by contracts that they signed, even if they did not read them and even if they did not have counsel. (Subsequent efforts to have the court reconsider its decision and to have the Supreme Court accept an interlocutory appeal were not successful.)

In *Solow v. Aspect Resources LLC*, 2007 WL 3256944 (Del. Ch., Oct. 30, 2007), the Chancery Court enforced a subpoena on a third party for electronic discovery and refused to order the party seeking discovery to pay more than copying and shipping costs in light of the failure of the responding party to establish that it would incur "significant expenses" as required under Rule 45(c)(2)(b).

In *Twin Bridges Limited Partnership v. Draper*, 2007 WL 44609 (Del. Ch., Sept. 14, 2007), the Chancery Court, in connection with a control contest among members of a family limited partnership, affirmed a hallowed Delaware principle that provides as follows: "inequitable action does not become permissible simply because it is legally possible." Based on

that maxim, the court allowed a breach of fiduciary duty claim to proceed, despite apparent compliance with the applicable statutes.

Conrad v. Blank, 2007 WL 2593540 (Del. Ch., Sept. 7, 2007). Much has been written already about this decision that allowed a stock option backdating claim to proceed.

In *The Follieri Group LLC v. Follieri/Yucaipa Investments, LLC*, 2007 WL 2459226 (Del. Ch., Aug. 23, 2007), the Chancery Court denied the effort of a putative creditor of the LLC sought to be dissolved, to intervene pursuant to either Chancery Court Rule 24(e) — as of right — or 24(b) — permissively. The court reasoned that if a dissolution were ultimately ordered of this LLC (whose members include the rich and famous), the dissolution statute for LLCs provides for dealing with creditors.

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In *Baldwin v. Carmack*, 2007 WL 2410377 (Del. Ch., Aug. 17, 2007), the Chancery Court refused to strike portions of a brief pursuant to Delaware Rule of Evidence 408 because the court found that none of the statements at issue were intended as offers of compromise or settlement. Moreover, the court explained that the exclusion of "statements or documents presented in the course of compromised negotiations when such statements are offered to prove a party's knowledge or understanding of certain disputed facts" are not prohibited by Rule 408.

In *Mercier v. Inter-Tel (Delaware), Inc.*, 2007 WL 2332454 (Del. Ch., Aug. 14, 2007), the Chancery Court provides a veritable "mini-textbook" on the Delaware corporate law that applies to the review of actions taken by directors in connection with shareholder votes on a merger, especially when no serious entrenchment claim

exists. The court applied the compelling justification standard from the Supreme Court's *Blasius* decision as well as the *Unocal* decision in connection with director conduct that affects a corporate election touching a corporate control but also offered a new perspective on the appropriate standards that should apply.

Nonetheless, the court rejected a request for a preliminary injunction and rejected the argument that directors have no discretion as fiduciaries to reschedule a vote once a stockholder meeting is imminent and the directors know that the vote won't go their way if it is held as originally scheduled.

In *re: infoUSA Inc. Shareholders Litigation*, 2007 WL 2332543 (Del. Ch., Aug. 13, 2007) (revised on Aug. 20, 2007). In this Chancery Court decision, which serves as a litigator's guide on how to successfully plead a derivative case to challenge allegedly excessive executive compensation, the court allowed a claim for excessive compensation to proceed.

In explaining how such a claim should be presented, as well as explaining the best way to plead a breach of fiduciary duty claim, the court explained that "a skilled litigant and particularly a derivative plaintiff, recognizing the institutional advantages and competency of the judiciary reflected in our law, places before the court allegations that question *not the merits of a director's decision*, a matter about which a judge may have little to say, but allegations that *call into doubt the motivations or the good faith of those charged with making the decision.*" (emphasis added).

The court's decision included a classic quote that emphasizes why the business judgment rule is not a "blank check." The court stated that "the rule does not require the court to bless the conclusion of a director that is self-evidently nonsense on stilts, nor does it protect a board that looks into the sun and names it the moon."

Moreover, the court continued: "Where, as here, the directors sought shareholder approval of an amendment to a stock option plan that could potentially enrich themselves and their patron, their concern for complete and honest disclosure should make Caesar appear positively casual about his wife's infidelity."

In *re Tyson Foods Inc., Consolidated Shareholder Litigation* (Del. Ch., Aug. 15, 2007). This Chancery Court decision allowed a claim for spring-loading of stock options to proceed. The court noted that the fiduciary duties of loyalty, good faith

Review continues on page 6

Review

Continued from page 5

and candor were “not adorned by the Delaware Supreme Court with half-hearted adjectives.” Rather, the court emphasized: “Directors should not take a seat at the board table prepared to offer only conditional loyalty, tolerable good faith, reasonable disinterest or formulistic candor.”

In *Brandon v. Deason* (Del. Ch., July 20, 2007), the Chancery Court denied a motion to stay a Delaware derivative action, despite a parallel proceeding in Texas, due to the important, substantive issues of Delaware law that the court determined should be decided in Delaware. Here is the money quote: “The stockholders of companies incorporated in this state would suffer a disservice if Delaware courts suddenly became a forum of last resort, available only for that small percentage of representative suits which do not, at least in theory, overlap with issues of the federal securities laws.”

In *TD Banknorth Shareholders' Litigation* (Del. Ch., July 19, 2007), the Chancery Court rejected a class action settlement concluding that the plaintiffs unreasonably failed to press legitimate legal claims against the defendants before consenting to a settlement.

Two cases decided within a day of each other granted expedited injunctive relief to put a hold on going-private transactions at two separate public companies due to the failure of the companies to disclose material information to shareholders who were asked to approve those transactions. See *In re Lear Corp. Shareholders Litigation* (2007 WL 1732588) (Del. Ch., June 15, 2007) and *In re Topps Co. Shareholders*

Litigation (2007 WL 1732586) (Del. Ch., June 14, 2007). Much has already been written on these two cases.

In *Desimone v. Barrows* (Del. Ch., June 7, 2007), the court dismissed claims against directors in connection with the backdating of options, after a scholarly review of the extensive facts and legal issues, as well as distinguishing other cases on similar topics.

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In *Metcap Securities, LLC v. Pearl Senior Care Inc.*, 2007 WL 1498989 (Del. Ch., May 2007), the court addressed various issues raised by a “deal lawyer” or a “deal counsel” whose scope of representation was not entirely clear. The court warned that the conflict presented by the so-called “deal lawyer” representing more than one party, created factual issues regarding the scope of his authority in connection with the finalizing of documents, and that those issues would need to be resolved by the ethical rules that control the conduct of lawyers. Footnotes 71 and 79 of the opinion should be required reading for anyone

considering himself or herself to be a “deal lawyer.”

Pershing Square, LP, v. Ceridian Corp., 2007 WL 1428444 (Del. Ch., May 11, 2007). The Chancery Court, after a trial, denied a request by a hedge fund/shareholder for documents under Section 220 of the Delaware General Corporation Law (DGCL) based on a failure to satisfy the “proper purpose” requirement. This is another of many examples of a large amount of money and time spent seeking books and records under Section 220 only to come up short. Notably, as a procedural matter, the complaint was filed on March 7, 2007, and after expedited discovery, a trial was held on April 11, 2007, and a formal decision issued shortly thereafter.

As in the *Brandon* case mentioned above, the Chancery decision in the case of *In re The Topps Co. Shareholders' Litigation*, 2007 WL 1412990 (Del. Ch., May 9, 2007) (separate from a later decision in the same case), determined that despite other suits being filed first involving the same parties and issues, cases filed in Delaware may be allowed to proceed if the issues are such that Delaware has a supervening interest in the interpretation and application of its own law, especially based on the policy reasons that support the internal affairs doctrine. The court denied a motion to stay despite a result that might otherwise have applied based on the “first filed rule.”

In *HIFN Inc., v. Intel Corp.*, 2007 WL 1309376 (Del. Ch., May 1, 2007), the Chancery Court decided an issue of first impression regarding rights and remedies available to a repudiating and a non-repudiating party to a contract. The court reasoned that the better rule is to “allow a party to repudiate without prejudice to its right later to contend that it was excused from performing because it turned out the non-repudiating party could not have performed anyway.”

In *Enodis Corp. v. Amana Co.*, (Del. Ch., April 26, 2007), the court maintained a stay of a case in favor of an adversary action in bankruptcy court filed by a trustee when that adversary action involved substantially the same issues as the case filed in the Chancery Court. The bankruptcy filing predated the Chancery Court case, and the Chancery Court decision was based largely on general bankruptcy principles.

In re Netsmart Technologies, Inc., Shareholders' Litigation (Del. Ch., March 14, 2007). In this Chancery Court decision, involving a private equity deal that

Review continues on page 11

Review

Continued from page 6

certain shareholders sought to enjoin, the Chancery Court ruled: (i) the board did not have a reasonable basis for failing to undertake any exploration of interest by strategic buyers; (ii) the plaintiffs established a probability that the proxy is materially incomplete because it failed to disclose projections used to perform a discounted cash flow valuation that supported the fairness opinion.

However, the court merely enjoined the merger vote until more information was disclosed.

In *Valeant Pharmaceuticals International v. Jerney*, 2007 WL 704935 (Del. Ch., March 1, 2007), the Chancery Court ordered the return of an excessive bonus based on a failure of the former director and president to prove the entire fairness of the decision resulting in a payment being paid to him in the amount of \$3 million.

In *Perlegos v. Armel Corp.*, 2007 WL 475453 (Del. Ch., Feb. 8, 2007), the court determined that the cancellation of a special shareholders' meeting was improper. Pursuant to DGCL Section 211, the plaintiff sought an order that a special meeting of shareholders should be held as noticed originally, based on the bylaws. The court

determined that the new chairman was technically authorized to cancel it but that the new chairman and the new board lacked proper and sufficient reasons to do so.

It was not merely the postponement of the meeting that was problematic, but rather, the result of the cancellation of the meeting was that it prevented the shareholders from voting on the removal of the director defendants until the next scheduled annual meeting about nine months later. Thus, the court held that the special meeting needed to be held. This case includes a thorough discussion of *Blasius* and related standards.

Two key decisions were issued on Feb. 6, 2007.

In *Ryan v. Gifford*, 2007 WL 416162 (Del. Ch., Feb. 6, 2007), the court denied a motion to dismiss certain claims alleging that the approval or acceptance of backdated options was a violation of the duties of care and loyalty as they were in violation of a shareholder approved stock option plan. The court refused to defer to similar pending litigation in California. The second decision issued on the same day related to claims in connection with spring-loaded stock options, *In Re Tyson Foods, Inc., Consolidated Shareholder Litigation* (Del. Ch., Feb. 6, 2007) 2007 WL 416132 (separate from a later decision in the same case).

Much has been written elsewhere on these opinions. For example, Professor Larry Ribstein has commentary at the following link: http://busmovie.typepad.com/ideoblog/2007/02/more_on_chandle_1.html (his blog writings were also cited by the court in the *Tyson* opinion).

Of course there were many more decisions of import over the past year from Delaware's Chancery and Supreme courts, about 200 of which I summarized on my blog in 2007. Most of the decisions could be (and have been) the subject of their own separate articles. The point here was merely a quick overview of issues addressed by a few of the cases that I thought were either especially noteworthy or that would be of interest to most business lawyers or business litigators from a practical viewpoint.

Note: Prior reviews of selected cases from Delaware courts from 2006 and 2005 are available at the following citations: *Review of Corporate Decisions by Delaware Courts in 2006*; Bloomberg Law Reports (Feb. 2007), and are also available at www.delawarelitigation.com/2007/03/articles/selected-articles-by-francis/summary-of-delaware-corporate-cases-for-2006/, and *Review of Selected 2005 Delaware Chancery Court and Supreme Court Cases*, 15 *Andrews Del. Corp. Lit. Rep.* 12 (2006). •