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OF THE
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Re: *Southeastern Pennsylvania Transportation Authority v. Volgenau*
C.A. No. 6354-VCN
Date Submitted: May 24, 2012

Dear Counsel:

By its Verified Second Amended Class Action Complaint (the "Complaint" or "Compl."), Plaintiff Southeastern Pennsylvania Transportation Authority ("SEPTA"), a former stockholder of Defendant SRA International, Inc. ("SRA" or the "Company"), challenges the merger (the "Merger") of SRA and affiliates of Defendant Providence Equity Partners LLC ("Providence"). SRA and several

members of its board of directors (the "Board") before the Merger—Defendants John W. Barter, Larry R. Ellis, Miles R. Gilburne, W. Robert Grafton, William T. Keevan, Michael R. Klein, Stanton D. Sloane, and Gail R. Wilensky (collectively, the "Individual SRA Defendants" and with SRA, the "SRA Defendants")—have moved for judgment on the pleadings on Count IV of the Complaint. For the reasons set forth below, that motion is granted in part and denied in part.[1]

* * *

"Under Court of Chancery Rule 12(c), judgment on the pleadings will be granted 'if the pleadings fail to reveal the existence of any disputed material fact and the movant is entitled to judgment as a matter of law.'"[2] "This standard is 'almost identical' to the standard for a Rule 12(b)(6) motion to dismiss."[3] "In ruling on a motion for judgment on the pleadings, the Court must take the well-pled facts alleged

[1] The SRA Defendants' motion for judgment on the pleadings presents a very narrow issue of law. Therefore, in this letter opinion, the Court will not provide a detailed description of the Merger or its factual background. Instead, the Court will refer to those facts that are necessary to its analysis.
[2] *Graulich v. Dell Inc.*, 2011 WL 1843813, at *4 (Del. Ch. May 16, 2011) (quoting *West Coast Mgmt. & Capital LLC v. Carrier Access Corp.*, 914 A.2d 636, 641 (Del. Ch. 2006)).
[3] *Avnet, Inc. v. H.I.G. Source, Inc.*, 2010 WL 3787581, at *4 (Del. Ch. Sept. 29, 2010) (quoting *Ross Hldg. & Mgmt. Co. v. Advance Realty Gp., LLC*, 2010 WL 1838608, at *5 (Del. Ch. Apr. 28, 2010)).

in the complaint as true, and view 'the inferences to be drawn from such facts in a light most favorable to the non-moving party.'"[4]

* * *

Count IV of the Complaint provides in pertinent part:

> The Company's Amended and Restated Certificate of Incorporation states that upon the merger or consolidation of the Corporation (whether or not the Corporation is the surviving entity), holders of each class of Common Stock will be entitled to receive equal per share payments or distributions. Here, the Merger contemplates different consideration for [Defendant Ernst] Volgenau [, SRA's alleged controller,] who is rolling a portion of his class B shares into equity ownership of SRA as a private company. That renders the Merger invalid under the Company's Certificate of Incorporation.
>
> By approving the invalid Merger, which violates the Certificate of Incorporation, the Individual Defendants [which includes Volgenau] have breached their fiduciary duty of loyalty to the public stockholders of SRA.[5]

SEPTA brings the Complaint as a purported direct class action on behalf of itself and all other similarly situated former common stockholders of SRA. Moreover, although the Complaint initially sought injunctive relief, SEPTA abandoned the effort and the Merger has been consummated.

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[4] *Graulich*, 2011 WL 1843813, at *4 (quoting *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P.*, 624 A.2d 1199, 1205 (Del. 1993)).
[5] Compl. ¶ 122-23.

* * *

The SRA Defendants dispute the underlying merits of Count IV, but that is not the basis for their current motion. Instead, the SRA Defendants argue that the claims presented in Count IV fail as a matter of law because they are procedurally barred by 8 *Del. C.* § 124, which states:

> **No act of a corporation** and no conveyance or transfer of real or personal property to or by a corporation **shall be invalid by reason of the fact that the corporation was without capacity or power** to do such act or to make or receive such conveyance or transfer, **but such lack of capacity or power may be asserted**:
>
> (1) **In a proceeding by a stockholder against the corporation to enjoin the doing of any act** or acts or the transfer of real or personal property by or to the corporation. . . ;
>
> (2) **In a proceeding by the corporation**, whether acting directly or through a receiver, trustee or other legal representative, or through stockholders in a representative suit, against an incumbent or former officer or director of the corporation, for loss or damage due to such incumbent or former officer's or director's unauthorized act;
>
> (3) **In a proceeding by the Attorney General** to dissolve the corporation, or to enjoin the corporation from the transaction of unauthorized business.[6]

[6] Emphasis added.

The SRA Defendants' argument is straightforward. Under 8 *Del. C.* § 124, a claim that corporate action is "invalid by reason of the fact that the corporation was without capacity or power" must be brought as a claim for injunctive relief or as a derivative claim, or it must be a claim initiated by the Attorney General. Therefore, Count IV, which alleges that "the Merger [was] invalid under the Company's Certificate of Incorporation," and that "[b]y approving the invalid Merger . . . the Individual Defendants have breached their fiduciary duty of loyalty," cannot form the basis for a non-injunctive direct claim against any of the SRA Defendants.

SEPTA responds that Count IV presents two claims—a contract claim and a fiduciary duty claim. With regard to the contract claim, SEPTA contends that, in the Merger, Volgenau received some consideration that was different from the consideration received by SRA's other common stockholders. That, according to SEPTA, violates SRA's certificate of incorporation, which allegedly provides that all of the Company's common stockholders must receive equal per share payments in a merger. SEPTA, describing SRA's certificate of incorporation as a contract, argues that the Board's approval of the Merger constituted a breach of contract, which rendered the Merger invalid and voidable. With regard to the fiduciary duty claim,

SEPTA argues that the Individual SRA Defendants "have breached their fiduciary duties of loyalty and care to SRA's public stockholders by favoring Volgenau in the distribution of . . . [Merger] consideration, by ignoring their known fiduciary and contractual duties and by being grossly negligent regarding the requirements of the Certificate. That conduct further renders the . . . [Merger] voidable."[7]

* * *

By 8 *Del. C.* § 124: "No act of a corporation . . . shall be invalid by reason of the fact that the corporation was without capacity or power to do such act . . . but such lack of capacity or power may be asserted . . . [in three defined instances]." Section 124's focus on the validity of corporate acts makes sense in light of its purpose, which was to prevent both corporations and those contracting with them from avoiding contracts that could be classified as "outside the scope of the . . . [corporation's] authorized powers."[8] Predictability and confidence in the efficacy of

[7] Pl.'s Answering Br. in Opp'n to the SRA Defs.' Mot. for J. on the Pleadings as to Count IV of the Second Am. Compl. at 16.

[8] DAVID A. DREXLER, ET AL., DELAWARE CORPORATION LAW AND PRACTICE ("CORPORATION LAW AND PRACTICE") § 11.05 (2011) ("Broadly stated, the ultra vires doctrine which Section 124 abolishes declared that a corporation, or a party contracting with a corporation, could assert as a defense in a suit to enforce its or his obligations under such contract that, in entering into the otherwise lawful contract, the corporation acted outside the scope of . . . its authorized powers. It

an agreement were the commercially reasonable objectives. With these purposes in mind, Section 124 only provides that acts will be deemed valid and that the corporation's capacity to undertake them may not, in most instances, be challenged. Section 124 does not bar all challenges to the acts it covers. It merely provides that certain acts may not be set aside because they are *ultra vires*. A corporation's act, through its directors, may be deemed valid and effective, but the act may nevertheless constitute a breach of fiduciary duty.[9]

A challenge to the validity of an action or to the corporation's capacity to undertake that action seeks to make the action void. It is a claim that the act could not occur. That is what 8 *Del. C.* § 124 speaks to: it says that the corporate actions will not be set aside and that capacity can only be challenged in three instances.[10] Although corporate actions may be deemed valid, it does not follow, however, that the conduct of those persons who caused such actions to occur may not be challenged

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was a double-edged sword, available under certain circumstances to both corporations and those contracting with corporations to escape from their contractual liabilities.").

[9] *See Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) ("[I]nequitable action does not become permissible simply because it is legally possible.").

[10] *See* 1 EDWARD P. WELCH, ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 124.1 (5th ed. 2012) ("Section 124 severely constricts the categories of claimants who may challenge an act as *ultra vires*."); CORPORATION LAW AND PRACTICE § 11.05 ("Section 124 of the statute, first adopted by the 1967 revision, abolishes the doctrine of ultra vires in Delaware, except in three narrow circumstances.").

on legal or equitable grounds. Indeed, this Court has determined that direct claims by shareholders for breach of a certificate of incorporation are permissible.[11] When a corporation undertakes an act in violation of its certificate of incorporation that act may stand,[12] but it may also be the basis for a direct shareholder lawsuit.[13]

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[11] *See Blue Chip Capital Fund II Ltd. P'ship v. Tubergen*, 906 A.2d 827, 828 (Del. Ch. 2006) ("A minority preferred stockholder claims that the board breached the company's certificate of incorporation when, after the sale of substantially all of the company's assets, it distributed an inflated amount of the proceeds to the holders of a class of preferred stock which included the company's controller. The stockholder brings this suit both derivatively and directly against the individual directors for breach of fiduciary duty and against the company for breach of contract and for breach of an implied covenant of good faith and fair dealing. . . . The court concludes that the allegations are sufficient to sustain a direct claim against the company for breach of contract and breach of the implied covenant of good faith and fair dealing."); *Gale v. Bershad*, 1998 WL 118022, at *1 (Del. Ch. Mar. 4, 1998) ("Gale brought this suit against Axsys and its three directors . . . alleging that they had caused Axsys to redeem the Preferred at an unreasonably low and unfair price, in violation of contractual [Axsys's certificate of incorporation] and fiduciary duties owed to the Preferred stockholders. For the reasons set forth below, I grant defendants' motion to dismiss the breach of fiduciary duty claim, but deny the motion to dismiss the breach of contract claims.").

[12] 8 *Del. C.* § 124.

[13] *Blue Chip*, 906 A.2d at 834. The Court recognizes that 8 *Del. C.* § 124 identifies only three instances in which a corporation's lack of power or capacity may be asserted, and that list does not include non-injunctive direct stockholder claims. Thus, a corporation's lack of capacity or power may not be asserted in a non-injunctive direct stockholder action, such as the one currently before the Court. Although SEPTA cannot, in this action, challenge SRA's ability to undertake the Merger, that does not mean that SEPTA cannot contend that the Merger violated the Company's certificate of incorporation. Because of 8 *Del. C.* § 124, the Merger is deemed valid, and, in this action, there can be no challenge to SRA's capacity to undertake the Merger. Those determinations, however, do not prevent SRA's former shareholders from claiming that the Individual SRA Defendants breached their fiduciary duties by causing SRA to take actions violative of rights enshrined in—that most important of corporate contracts—the certificate of incorporation. A corporation could not, for example, implement the common law fiduciary duties of its directors into its certificate of incorporation, and then claim that any direct non-injunctive claims for breach of fiduciary duty are barred by 8 *Del. C.* § 124.

SEPTA has taken some liberties in characterizing Count IV. The Court, however, relies on the actual text of the Complaint. Count IV presents two claims. First, "the Merger [is] invalid under the Company's Certificate of Incorporation."[14] Second, "[b]y approving the invalid Merger, which violates the Certificate of Incorporation, the Individual Defendants have breached their fiduciary duty of loyalty to the public stockholders of SRA."[15]

Moreover, 8 *Del. C.* § 124 only speaks to the validity of acts by a corporation: "No act of a *corporation* . . . shall be invalid by reason of the fact that the corporation was without capacity or power to do such act . . . but such lack of capacity or power may be asserted . . . [in three defined instances]." (emphasis added). "A statutory limit on the parties who may bring an action asserting the lack of, or a limitation upon, the authority of a corporation does not encompass a suit challenging whether an individual had authority to act on behalf of a corporation to sell a corporation's property." 19 C.J.S. Corporations § 678 (2012) (citing *Solon Chamber of Commerce v. Women's Gen. Hosp.* 612 N.E.2d 331 (Ohio Ct. App. 1992)). *See also Mortgage Invs. Corp. v. Battle Mountain Corp.*, 70 P.3d 1176, 1182 (Colo. 2003) ("Colorado's ultra vires statute . . . prohibits an individual's claim that a corporation is acting beyond the scope of its power. This provision is designed to prevent challenges to a *corporation's* power to act. A corporation is a separate entity distinct from its officers. . . . Here, the question is whether Tucker had the power to act for the corporation, not whether the corporation had the power to act. Whether or not an individual has the authority to act on behalf of the corporation, as an officer, or purported officer, is a question of authority governed by principles of agency law.") (citations omitted).

The line between a corporation's invalid acts and the conduct of directors in causing the corporation to undertake those acts is a fine one, but it does exist. The General Assembly could have stated in 8 *Del. C.* § 124 that a director's decision to cause a corporation to take an act in violation of the corporation's certificate of incorporation shall not constitute a breach of that director's fiduciary duties. But the General Assembly did not do that. Instead, it enacted a statute directed solely to the acts of corporations that are beyond challenge or that may only be challenged in a limited manner.

[14] Compl. ¶ 122.

[15] *Id.* at ¶ 123.

Under 8 *Del. C.* § 124, the Merger is effectively deemed valid, and SEPTA has lost its opportunity to challenge the corporation's capacity to enter into the Merger. Thus, the claim in Count IV that the Merger is invalid is barred, and SEPTA lacks standing to assert SRA's lack of capacity. Nonetheless, the conduct of the fiduciaries who approved the Merger, which is deemed to be a valid act, may still be challenged on the basis that it was carried out in violation of SRA's certificate of incorporation. That challenge, in this case, has been properly asserted as a claim for breach of fiduciary duty.[16] SEPTA may state a direct claim that the Individual SRA Defendants breached their fiduciary duties by approving the Merger, which violates SRA's certificate of incorporation, even though SEPTA may not challenge the validity of the Merger or even challenge SRA's capacity to enter into the Merger.[17]

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[16] The Court need not, at this stage, determine whether a decision of directors to cause the corporation they direct to take an action which violates the corporation's certificate of incorporation is a breach of the duty of care or of the duty of loyalty. Nevertheless, a decision to cause a corporation to take an act in violation of its certificate of incorporation would appear analogous to a decision to cause the corporation to take an illegal act, which is typically viewed as a breach of the duty of loyalty. *See Hampshire Gp. Ltd. v. Kuttner*, 2010 WL 2739995, at *2 (Del. Ch. July 12, 2010) ("By consciously causing the corporation to violate the law, Clayton breached his duty of loyalty and is responsible for the corporation's costs of investigating and rectifying that misconduct.").

[17] This determination may have little effect for at least two reasons. First, it is not likely to reach far beyond the sale context. If a director causes the corporation she directs to undertake an *ultra vires* act during the corporation's on-going operations (i.e., not in the sale context), then a shareholder, such as SEPTA, will likely not have standing to bring a direct claim against that director. Any harm

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from a director's *ultra vires* action during a corporation's on-going operations would likely inure to the corporation itself, and thus, would only provide a basis for a derivative claim. *See Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1033 (Del. 2004) ("We set forth in this Opinion the law to be applied henceforth in determining whether a stockholder's claim is derivative or direct. That issue must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"). *But see Gentile v. Rosette*, 906 A.2d 91, 99 (Del. 2006) ("There is, however, at least one transactional paradigm—a species of corporate overpayment claim-that Delaware case law recognizes as being both derivative and direct in character.") (citation omitted). Second, there has been no contention that 8 *Del. C.* § 124 alters shareholders' ability to sue directors for their failure to adhere to certain sale context doctrines such as those developed in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994). The SRA Defendants have not suggested that shareholders' ability to sue directly for violations of those common law doctrines was ever in doubt. Thus, the determination that a shareholder can state a direct claim against a board for breaching its fiduciary duties by causing the corporation to undertake a transaction that violates its certificate of incorporation is only likely to have an effect in a sale situation where a corporation's certificate of incorporation provides more protection than what is available at common law. If the protections in the certificate of incorporation are equivalent to or less than the protections available at common law, then any claim for violation of the certificate of incorporation will be duplicative of or less effective than a claim under common law.

Allowing SEPTA's claim for breach of fiduciary duty in Count IV to proceed, however, may be important in this case. It is much too early to determine what exactly happened in this case, but the Merger appears to have been a transaction in the nature of *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009) and *Frank v. Elgamal*, 2012 WL 1096090 (Del. Ch. Mar. 30, 2012). But here "robust procedural protections" may have actually been utilized, and thus, the transaction may be subject, at common law, to review under the business judgment rule. *See Frank*, 2012 WL 1096090, at *8 ("[B]usiness judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, *and* (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.") (quoting *Hammons*, 2009 WL 3165613, at *12). SRA's certificate of incorporation, however, may demand more than the robust procedural protections discussed by this Court in *Hammons* and *Frank*. Thus, SEPTA's claim for breach of fiduciary duty in Count IV could conceivably be the Complaint's one ultimately successful claim. SEPTA, of course, will likely only be able to recover on that claim if it can show damages flowing from the disparate treatment that Volgenau received.

For the foregoing reasons, SEPTA's claim that the Merger is invalid fails as a matter of law, but, at this stage, the Individual SRA Defendants are not entitled to judgment on SEPTA's claim that they breached their fiduciary duties by approving a transaction that violated SRA's certificate of incorporation.

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K