RICHARDS, LAYTON & FINGER
A PROFESSIONAL ASSOCIATION
ONE RODNEY SQUARE
920 NORTH KING STREET
WILMINGTON, DELAWARE 19801
(302) 651-7700
FAX: (302) 651-7701
WWW.RLF.COM

July 11, 2007

Re: <u>Recent Delaware Corporate Law Decisions</u>

In the past few months, the Delaware courts have issued several opinions that raise important issues for Delaware corporations and their advisors. For example, in three recent cases, the Court of Chancery analyzed go-shop provisions and other aspects of deal protection packages in the context of a target board's *Revlon* duties. *In re Lear Corp. S'holder Litig.*, C.A. No. 2728-VCS (Del. Ch. June 15, 2007); *In re The Topps Co. S'holders Litig.*, C.A. Nos. 2786-VCS & 2998-VCS (Del. Ch. June 14, 2007); *Berg v. Ellison*, C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (TRANSCRIPT). In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, No. 521, 2006 (Del. May 18, 2007) ("*NACEPF*"), the Delaware Supreme Court definitively established that corporate directors do not owe a direct fiduciary obligation to individual creditors of a corporation that is either insolvent or operating in the zone of insolvency. In *MBKS Company Limited v. Reddy*, C.A. No. 1853-VCL (Del. Ch. Apr. 30, 2007), the Court of Chancery discussed the distinction between void and voidable issuances of stock in the context of granting a motion for summary judgment in a dispute over the identity of the rightful stockholders and directors of two Delaware corporations. In *Levy v. HLI Operating Company, Inc.*, C.A. No. 1395-VCL (Del. Ch., May 16, 2007), the Court of Chancery held that (i) corporate directors have no right of indemnification against a corporation when the sums for which indemnification is sought were paid by third parties on the directors' behalf, and (ii) Section 145 of the General Corporation Law of the State of Delaware ("DGCL") prohibits contractual provisions requiring indemnification for fees and expenses incurred while prosecuting an indemnification claim regardless of whether the former director was ultimately determined to be entitled to indemnification. In *In re Appraisal of Transkaryotic Therapies, Inc.*, C.A. No. 1554-CC (Del. Ch. May 2, 2007), the Court of Chancery determined that a stockholder of record who holds shares on behalf of numerous beneficial owners may perfect appraisal rights under 8 *Del. C.* § 262 without demonstrating that the particular shares for which appraisal is sought were not voted in favor of the merger, provided the total number of shares held by the record stockholder and not voted in favor of the merger exceeds the number of shares for which that record stockholder seeks appraisal. Finally, in *Gatz v. Ponsoldt*, No. 298, 2006 (Del. Apr. 16, 2007), the Delaware Supreme Court considered the circumstances in which plaintiffs may bring direct claims for breach of fiduciary duty.

In addition, the Delaware Constitution was recently amended to allow the United States Securities and Exchange Commission to certify questions of law to the Delaware Supreme Court, and legislation amending certain provisions of the DGCL has been adopted by the Delaware

General Assembly and is expected to be signed into law by the Governor of the State of Delaware.

Go-Shop Provisions and Deal Protection Devices Under *Revlon*: *In re Lear Corp. S'holder Litig.*; *In re The Topps Co. S'holders Litig.*; *Berg v. Ellison*

In three recent cases, the Court of Chancery analyzed go-shop provisions and other aspects of deal protection packages in the context of a target board's *Revlon* duties. *In re Lear Corp. S'holder Litig.*, C.A. No. 2728-VCS (Del. Ch. June 15, 2007); *In re The Topps Co. S'holders Litig.*, C.A. Nos. 2786-VCS & 2998-VCS (Del. Ch. June 14, 2007); *Berg v. Ellison*, C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (TRANSCRIPT).

In *Topps*, the plaintiffs claimed, among other things, that the board had breached its *Revlon* duties by entering into a definitive merger agreement prior to conducting a public auction. The Court rejected this claim, finding that the board had left itself "reasonable room for an effective post-signing market check" by negotiating a merger agreement that included a go-shop provision allowing the board to negotiate with competing bidders that it identified during a 40-day period as having submitted (or as being reasonably likely to submit) a superior proposal. Under this provision, a reduced break-up fee would be payable if the company terminated the agreement in order to accept a superior proposal during the 40-day go-shop period, regardless of whether an agreement with respect to the superior proposal had been executed prior to the expiration of such period.

In *Lear*, the Court found that the plaintiffs were unable to demonstrate that the board of directors had breached its *Revlon* duties, even though the board had caused the company to enter into a merger agreement without engaging in a full pre-signing auction. In reaching this conclusion, the Court noted that (i) the board had conducted a pre-signing market check that yielded no serious bids; (ii) the merger agreement between the company and the potential acquirer contained a termination fee within the range of reasonableness; and (iii) the potential acquirer agreed to vote its 24% interest in the company's common stock in favor of any superior proposal it did not match. The Court gave little weight to the merger's go-shop provision, which it called "truncated," because the provision's reduced break-up fee would be payable only where the existing agreement had been terminated *and* the competing bidder had entered into a definitive agreement within the 45-day period. The Court noted the practical difficulties that a competing bidder would encounter in seeking to satisfy the terms of the *Lear* go-shop provision within the 45-day period.

In *Berg*, the Court denied the plaintiffs' motion to expedite proceedings, but in doing so expressed the view that the 25-day go-shop provision, which was similar to the provision in *Lear*, was of limited value, noting the practical difficulty that a competing bidder would face when seeking to enter into a definitive agreement within a 25-day period.

In all three cases, the Court's *Revlon* analysis considered the facts and circumstances surrounding the transactions, providing helpful guidance for deal planners. In *Topps*, the Court noted that the 40-day go-shop was reasonable and that the match right was similar to match rights that have "frequently been overcome in other real-world situations." While noting that the post-go-shop termination fee of 4.3% of total deal value was a bit high, the Court highlighted that such figure included the bidder's expenses and could be explained by the "relatively small size of the deal." Ultimately, the Court found that such fee was unlikely to have deterred an interested bidder. The Court granted the plaintiffs' preliminary injunction, however, finding that the target board had abused a standstill agreement with the competing bidder (which was also the target's principal competitor). The Court found that the target board had prevented the competing bidder from launching a tender offer, thus foreclosing the stockholders' chance of receiving a higher offer.

In *Lear*, the Court seemed unimpressed with the 45-day go-shop period because it "essentially required the bidder to get the whole shebang done within the 45-day window." The Court was untroubled by the initial bidder's match right and appeared to view favorably the agreement requiring the initial bidder to vote its 24% interest in favor of any unmatched superior proposal. Although the Court suggested that, due to the "truncated" go-shop period, it was unlikely that any bidder would be able to take advantage of the lower termination fee, the Court did not find the two-tiered termination fee (2.8% of equity value during the go-shop period and 3.5% thereafter) to be unreasonable in either case.

The Court's concerns in *Berg* were similar to those in *Lear*. The Court again seemed unconcerned with the match right and gave little weight to the two-tiered termination fee tied to the 25-day go-shop period. The Court's principal concern was the plaintiffs' argument that the termination fee was approximately 5% of the equity value. This concern dissipated once the Court learned that the fee was actually closer to 3.5% of the equity value, and the Court denied the plaintiffs' motion for expedited proceedings.

These three decisions represent important developments for M&A practitioners, especially with respect to the Court's analysis in each of go-shop provisions. However, the decisions are consistent with prior decisions of the Court of Chancery, pursuant to which the Court's *Revlon* analysis depended on the particular facts and circumstances of a transaction, such as pre-signing canvassing conduct as well as post-signing flexibility and impediments with respect to topping bids.

Fiduciary Duties Owed to Corporate Creditors: *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, No. 521, 2006 (Del. May 18, 2007) ("*NACEPF*"), the Delaware Supreme Court definitively established that corporate directors do not owe a direct fiduciary obligation to individual creditors of a corporation that is either insolvent or operating in the zone of insolvency.

More than 15 years ago, the Court of Chancery in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*.[1] introduced the phrase "zone of insolvency." Since *Credit Lyonnais*, many opinions and articles have been written on the subject of directors' fiduciary

[1] 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

duties to creditors once a corporation becomes insolvent or enters the zone of insolvency. Until now, however, the Delaware Supreme Court had never spoken on the issue.

It is well recognized that directors owe fiduciary obligations to the corporation and its stockholders. Because creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights, they are generally not owed fiduciary obligations.

In *NACEPF*, the Supreme Court directly addressed the long-debated question of whether corporate directors owe fiduciary obligations to creditors as a corporation slides towards insolvency. The Court explained that "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."

Likewise, the Court held that creditors may not bring direct fiduciary claims, even if the purported wrongdoing occurred during insolvency. Prior to *NACEPF*, the Court of Chancery had suggested that under a heightened pleading standard, creditors could theoretically bring such claims.[2] The Supreme Court ruled out such theoretical claims, and held that recognizing a right of creditors to bring fiduciary claims against directors of an insolvent company would create a conflict between a director's duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it and the direct fiduciary duty to the individual creditors.

The Supreme Court also reaffirmed that when a corporation is insolvent, creditors have standing to sue derivatively on behalf of the corporation for breaches of fiduciary duty. The Court did not, however, discuss whether creditors may bring derivative claims on behalf of a corporation that is operating in the zone of insolvency but is not actually insolvent. The Court's holding in *NACEPF* suggests that the right to do so may be limited.

Distinguishing Void and Voidable Stock Issuances: *MBKS Company Limited v. Reddy*

In *MBKS Company Limited v. Reddy*, C.A. No. 1853-VCL (Del. Ch. Apr. 30, 2007), the Court of Chancery discussed the distinction between void and voidable issuances of stock in the context of granting a motion for summary judgment in a dispute over the identity of the rightful stockholders and directors of two Delaware corporations ("MBKS I & II"). The genesis of the dispute was the 1995 formation of MBKS I & II by a British Virgin Islands corporation (the "BVI Parent") and an ensuing web of poorly documented agreements, resolutions and transactions. Although the record owner of MBKS I & II was the BVI Parent, which was in turn wholly owned by Sultan Khalid Bin Mahfouz ("Bin Mahfouz"), evidence indicated that MBKS I

[2] *See Big Lots Stores, Inc. v. Bain Capital Fund VII, L.L.C.*, 2006 WL 4515404 (Del. Ch. Mar. 28, 2006); *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

& II's operating activities were funded by Bin Mahfouz's cousin, Sami Baarma ("Baarma"), who had a long-standing business relationship with Bin Mahfouz and was responsible for all money and property management for the BVI Parent and MBKS I & II. Jagan M. Reddy ("Reddy") was appointed as an officer and director of MBKS I & II at the time of their formation in 1995, and at the same time was appointed as an officer and director of the BVI Parent.

The business and personal affairs of Baarma, Reddy, the BVI Parent, MBKS I & II and other entities controlled by Baarma were deeply intertwined, and little effort was made by Baarma or Reddy to properly document agreements and transfers of funds between the parties or to otherwise observe corporate formalities. Reddy was purportedly given an equity interest in the BVI Parent in 1996 in exchange for his investment in another Baarma-controlled entity. This agreement was not formally documented, and there was no formal issuance of shares to Reddy either in 1996 or at any other time prior to Baarma's death on March 12, 2005. Shortly after Baarma's death, Bin Mahfouz and Reddy, as the only directors of the BVI Parent, agreed to formally recognize Reddy's 25% interest in the BVI Parent, retroactive to October 21, 1994, and executed board resolutions to that effect (the "2005 Agreement").

The main dispute between the parties concerned a series of alleged agreements reached between Baarma and Reddy in 1996 and 1997. The first of these agreements purportedly granted Reddy a direct interest in MBKS I & II in exchange for a capital contribution, which was originally designed to allow MBKS I & II to act through a third entity to purchase additional property (the "Initial Issuance Agreement"). The Initial Issuance Agreement was memorialized in writing by a set of signed but undated resolutions, which were later dated and unilaterally modified by Reddy. The intended recipient of the capital contribution was subsequently changed by an undocumented oral agreement from MBKS I & II to several individuals designated by Baarma. Reddy and Baarma also allegedly entered into an undocumented oral agreement which provided that if a United States citizen became a record stockholder of the BVI Parent, then the BVI Parent would be required to distribute its stock in MBKS I & II to its stockholders (the "Required Distribution").

At the time they were negotiating the 2005 Agreement, Bin Mahfouz was unaware of the oral agreement between Reddy and Baarma setting forth the terms of the Required Distribution, and, despite the fact that the 2005 Agreement would trigger the Required Distribution, Reddy did not discuss the Required Distribution with Bin Mahfouz prior to finalizing the 2005 Agreement.

Baarma's death left Reddy as the sole director of MBKS I & II, and Reddy acted in such capacity and passed resolutions in August 2005 to (i) issue stock of MBKS I & II to himself pursuant to the Initial Issuance Agreement, and (ii) cancel the existing stock of MBKS I & II that was held by the BVI Parent. It was not until after Reddy took these actions and after his family received a $6.1 million settlement from Bin Mahfouz and others relating to Baarma's estate in October 2005 that Reddy disclosed the Required Distribution to Bin Mahfouz. Shortly thereafter, Reddy resigned as a director of the BVI Parent. Bin Mahfouz then took action through the BVI Parent to elect two directors to the boards of MBKS I & II on November 1, 2005 (the "November 1, 2005 Consents"), and then took further action to remove Reddy as a director of MBKS I & II on December 17, 2005 (the "December 17, 2005 Consents").

On December 20, 2005, MBKS I & II and the BVI Parent filed suit in the Court of Chancery seeking a declaratory judgment and other relief for alleged breaches of fiduciary duty, fraud, negligent misrepresentation and other misconduct committed by Reddy. In recognition of the fact that he had not paid any consideration to MBKS I & II pursuant to the Initial Issuance Agreement, Reddy purported to act as the sole director of MBKS I & II and pass resolutions on December 24, 2005 granting himself until the end of January 2006 to pay $680,000 to each of the corporations in exchange for the MBKS I & II stock.

The Court granted summary judgment in favor of the BVI Parent and MBKS I & II on the grounds that the BVI Parent must be recognized as the sole stockholder of MBKS I & II because (i) Reddy, acting only as the sole director of MBKS I & II, lacked legal power to cancel the validly issued shares of MBKS I & II registered in the name of the BVI Parent, as such action can only be accomplished through an amendment to MBKS I & II's certificates of incorporation approved and adopted by both the board of directors and the stockholders of each corporation; and (ii) the additional shares of MBKS I & II that Reddy purported to issue to himself are void or voidable for want of any valid consideration to those entities and must be disregarded in examining the sufficiency of the November 1, 2005 Consents and the December 17, 2005 Consents. Although Section 153 of the DGCL was amended in 2004 to expand the definition of "consideration" to include "any benefit *to the corporation*" (emphasis added), because Reddy granted himself stock in return for a promise to pay Baarma's designees rather than MBKS I & II, this case presents a rare example of a situation where consideration was found to be lacking under the present version of Section 153.

In addition to clarifying that the "cancellation" and reissuance of shares of a corporation's capital stock can only be accomplished through an amendment to a corporation's certificate of incorporation approved and adopted by the corporation's board of directors and stockholders in accordance with Section 242 of the DGCL, the Court attempted, in *dicta*, to clarify the somewhat murky jurisprudence on the issue of whether stock issued without adequate consideration is considered void or voidable. The Court indicated that equitable considerations such as the effect on third parties such as creditors and subsequent transferees that did not have knowledge of the defect will generally lead to the conclusion that such stock is voidable rather than void. Although the Court did not reach the question of whether the stock Reddy issued to himself was void or voidable since MBKS I & II had the right to cancel the stock if it was voidable and achieve the same result as if the stock had been void *ab initio*, the Court implied that in a situation such as the one presented here where the stock in question was (i) issued for no consideration to the corporation and (ii) still held by its original holder, such stock would likely be considered void rather than merely voidable.

Although the Court's ruminations in *dicta* may not necessarily indicate how the Court would rule on every fact pattern involving void or voidable stock issuances, this decision should provide a useful roadmap to practitioners on how such matters generally will be decided.

Directors' and Officers' Indemnification Rights: ***Levy v. HLI Operating Company, Inc.***

In *Levy v. HLI Operating Company, Inc.*, C.A. No. 1395-VCL (Del. Ch. May 16, 2007), the Court of Chancery: (i) denied a claim for indemnification by former officers and directors for monies paid by a third party on their behalf; (ii) invalidated a contractual provision requiring indemnification for fees and expenses incurred while prosecuting an indemnification claim regardless of whether the former director was ultimately determined to be entitled to indemnification; and (iii) clarified *Chamison v. Healthtrust*,[3] which distinguished between indemnification, contribution and subrogation in the context of directors with multiple indemnification agreements relating to their actions as directors.

The plaintiffs in *Levy* were former officers and directors of defendant HLI Operating Company, Inc. ("Old Hayes"), which was the subject of multiple lawsuits relating to financial restatements in 2001. Old Hayes filed for chapter 11 bankruptcy and, pursuant to a plan of reorganization, emerged as an operating subsidiary of the newly created Hayes Lemmerz International, Inc. ("New Hayes").

In 2005, the *Levy* plaintiffs agreed to pay $1.2 million each in order to settle certain Old Hayes lawsuits. Two of the plaintiffs personally paid their portions of the settlement amount, while the remaining four plaintiffs (the "JLL representatives") had their portions of the settlement amount paid by Joseph Littlejohn & Levy Fund II, L.P. (the "JLL Fund") pursuant to indemnification rights they possessed as representatives of the JLL Fund on the Old Hayes board of directors.

The plaintiffs sought indemnification from both Old Hayes and New Hayes pursuant to the bylaws, the indemnification agreements and the chapter 11 plan of reorganization. The indemnification requests were denied, and the plaintiffs filed an indemnification action in the Court of Chancery.

The Court held that the JLL representatives were entitled to indemnification for monies paid out of their own pockets, but they were not entitled to indemnification for monies paid on their behalf by the JLL Fund. Since their indemnifiable expenses were paid in full by the JLL Fund, the JLL representatives did not suffer an out-of-pocket loss, and therefore, the Court held that they lacked standing to bring a claim for indemnification under Section 145.

With respect to monies paid by the JLL Fund on behalf of the JLL representatives, the analysis was largely guided by the decision in *Chamison*. The Court held that the appropriate cause of action was one for equitable contribution[4] brought by the JLL Fund (not the JLL

[3] 735 A.2d 912 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000).

[4] "An equitable right of contribution arises when one of several obligors liable on a common debt discharges all, or greater than its share, of the joint obligation for the benefit of all the obligors…. In contrast to the rights of subrogation and indemnity, contribution will not relieve an obligor from the entire burden of a loss, but only from its equitable share." *Levy*, 2007 WL 1500032 at *6.

representatives) against Old Hayes/New Hayes. In reaching this conclusion, the *Levy* Court expressly rejected an equitable subrogation[5] argument that under *Chamison* the JLL Fund could "stand in the shoes" of the JLL representatives and maintain an indemnification action against Old Hayes/New Hayes.

Finally, the Court held that the JLL representatives were not entitled to indemnification for fees and expenses incurred while prosecuting their unsuccessful indemnification claims, despite language in the Old Hayes agreements requiring indemnification regardless of success on the merits. Citing *Stifel Financial Corp. v. Cochran*,[6] Section 145(e) and "sound public policy," the Court concluded that a party's right to such fees necessarily hinges upon its success in the underlying indemnification action and, accordingly, the Court invalidated the contractual provisions.

Perfecting Section 262 Appraisal Rights: *In re Appraisal of Transkaryotic Therapies, Inc.*

In *In re Appraisal of Transkaryotic Therapies, Inc.*, C.A. No. 1554-CC (Del. Ch. May 2, 2007), the Court of Chancery determined that a stockholder of record who holds shares on behalf of numerous beneficial owners may perfect appraisal rights under 8 *Del. C.* § 262 without demonstrating that the particular shares for which appraisal is sought were not voted in favor of the merger, provided the total number of shares held by the record stockholder and not voted in favor of the merger exceeds the number of shares for which that record stockholder seeks appraisal.

On April 21, 2005, Shire Pharmaceuticals plc ("Shire") and Transkaryotic Therapies, Inc. ("TKT") entered into a merger agreement under which TKT would become a wholly owned subsidiary of Shire and TKT stockholders would receive $37 per share in cash. The TKT board of directors set June 10, 2005 as the record date for determining which stockholders were entitled to vote on the proposed merger. Before the special meeting of stockholders on July 27, 2005, TKT received demands for appraisal from the holders of more than 11 million shares, or nearly a third of the shares entitled to vote, all of which were held of record by nominal petitioner Cede & Co. ("Cede"). At the meeting, approximately 52% of the shares entitled to vote were voted in favor of the merger, and soon thereafter the merger was consummated.

The beneficial owners who caused Cede to submit demands for appraisal on their behalf admitted in discovery that they had acquired over 8 million of the shares for which they sought appraisal after the record date, and that they had not acquired those shares with proxies or

[5] "In an action for subrogation, the insurer … may demand full payment from another party primarily responsible for the loss which the insurer both insured and reimbursed…. Subrogation differs from contribution because its operation rests on concepts of primary and secondary liability among obligors. Thus, it acts to place an entire loss, not just a portion, on another party. In contrast to indemnification, subrogation allows an insurer to succeed to a right of payment flowing to its insured, while an entity seeking indemnity must do so in its own right." *Levy*, 2007 WL 1500032 at *7.

[6] 809 A.2d 555 (Del. 2002).

otherwise secured the right to direct the vote of those shares. However, the aggregate number of shares held of record by Cede and not voted in favor of the merger exceeded the number of shares as to which Cede sought appraisal. TKT moved to disqualify the shares acquired after the record date from the appraisal action, on the grounds that the petitioners could not demonstrate compliance with the requirement of 8 *Del. C.* § 262(a) that the stockholder of record not vote in favor of the merger.

TKT's argument relied on the statutory text: Section 262(a) allows a stockholder of record to obtain the appraisal remedy only upon fulfillment of certain enumerated prerequisites, including delivery of a timely demand for appraisal, holding shares on the date of making demand, holding shares continuously through the effective date of the merger, and refraining from voting in favor of the merger. TKT argued that the statutory text required the stockholders seeking appraisal to fulfill the first three of these prerequisites as to the same shares. The statute requires the stockholder to hold "shares of stock" on the date of making demand, to make a demand for appraisal "with respect to such shares," and to hold "such shares" continuously through the effective date of the merger. However, rather than framing the final prerequisite in terms of "shares" not being voted in favor of the merger, the statute requires that the "stockholder" not vote in favor of the merger.

A literal reading of the statute thus apparently would bar the appraisal remedy to a stockholder of record who votes even a single share in favor of the merger, even if the stockholder of record is (like Cede) a mere nominee who lacks independent voting discretion. Delaware case law has long held, however, that a record holder may vote some of its shares in favor of a merger, other shares against the merger, and obtain appraisal as to the dissenting shares.[7] Accordingly, TKT argued, a stockholder seeking to establish its compliance with the appraisal statute must demonstrate that the particular shares as to which a demand was made were not voted in favor of the merger.

Under TKT's proposed reading of the statute, a beneficial owner who holds shares of stock through a nominee and seeks appraisal would bear the burden of showing how such shares were voted. Where the beneficial owner holds continuously from the record date through the effective date of the merger, such a showing could be made easily. On the other hand, where a beneficial owner acquires shares in the open market after the record date and does not purchase with proxy attached (or otherwise secure the right to direct the vote of such shares), the post-record date purchaser would need to show how the beneficial owner as of the record date directed the record holder to vote the shares. Because the appraisal petitioners admitted that they could not demonstrate that the shares they acquired after the record date were among those that Cede held but did not vote in favor of the merger, TKT argued that those shares should be disqualified from the appraisal proceeding.

The Court rejected TKT's proposed reading and held that the shares purchased after the record date were entitled to the appraisal remedy. The Court's analysis relied on the statutory

[7] *See Olivetti Underwood Corp. v. Jacques Coe & Co.*, 217 A.2d 683 (Del. 1966); *Reynolds Metals Co. v. Colonial Realty Corp.*, 190 A.2d 752 (Del. 1963).

text defining the term "stockholder" to refer exclusively to the stockholder of record and on precedents prohibiting inquiry into the relationships between Cede as record holder and the beneficial owners. On that basis, the Court held that only Cede's actions were relevant and that, because the number of shares Cede held and did not vote in favor of the merger exceeded the number of shares for which Cede demanded appraisal, Cede was entitled to appraisal for all shares as to which demand had been made.

Distinguishing Between Direct and Derivative Fiduciary Claims:
Gatz v. Ponsoldt

In *Gatz v. Ponsoldt*, No. 298, 2006 (Del. Apr. 16, 2007), the Delaware Supreme Court considered the circumstances in which plaintiffs may bring direct claims for breach of fiduciary duty.

In *Gatz*, a trust settled by William R. Ponsoldt, Sr., president, CEO, and chairman of the board of Regency Affiliates, Inc. ("Regency"), held shares of Series C Preferred and 38.9% of the common stock of Regency. The plaintiffs alleged that in December 2001, Ponsoldt caused one subsidiary of Regency to sell 75 million tons of valueless aggregate rock to another for an $18.2 million promissory note (the "Aggregate Sale") in order to increase the value of the Series C Preferred, which value was in certain respects tied to the value of the aggregate rock.

On October 17, 2002, in a recapitalization of Regency (the "recapitalization"), an affiliate of third-party investor Laurence Levy loaned cash to Regency in return for two promissory notes; one was nonconvertible and one was eventually converted into approximately 60% of Regency common stock. In the Recapitalization, Ponsoldt and Statesman Group, Inc. ("Statesman"), a company controlled by Ponsoldt, were largely cashed out and Statesman received a payment for, among other things, agreeing to an amendment of the certificate of designation for the Series C Preferred.

The plaintiffs brought suit challenging, *inter alia*, the Aggregate Sale and the Recapitalization. On the defendants' motions to dismiss, the Court of Chancery held that the plaintiffs' claims regarding the Recapitalization and (in a subsequent opinion) the Aggregate Sale were derivative and could not be brought directly. Thus, the Court dismissed the claims for the plaintiffs' failure to make the required demand on Regency's board of directors to bring the suit.

On appeal, the Delaware Supreme Court reversed, citing *In re Tri-Star Pictures, Inc.*[8] and *Gentile v. Rossette*.[9] In *Tri-Star*, the plaintiffs alleged that the Coca-Cola Company, a 56.6% stockholder of Tri-Star Pictures, Inc., caused Tri-Star to issue stock to Coca-Cola, increasing its stock to approximately 80%, in exchange for lower-priced Coca-Cola stock. The Court allowed the plaintiffs to bring a direct claim.

[8] 634 A.2d 319 (Del. 1993).

[9] 906 A.2d 91 (Del. 2006).

In *Rossette* (issued after the lower court's decision in *Gatz*), the plaintiffs alleged that a 61% stockholder of SinglePoint Financial, Inc. had forgiven SinglePoint's debt to him in exchange for the issuance of more valuable SinglePoint stock, increasing his stock to 95%. The Court held that *Tri-Star* controlled:

> 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. A breach of fiduciary duty claim having this dual character arises where: (1) a stockholder having majority or effective control causes the corporation to issue excessive shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders.

Gatz stated that the "one significant factual difference between this case and the facts alleged in *Tri-Star* and *Rossette*" was that a third party, Royalty Holdings, L.L.C. ("Royalty"), not the controlling stockholder, received the stock. The Court characterized the Recapitalization as properly analyzed as two transactions. In the first, Statesman became majority stockholder in Regency. In the second, Royalty received shares of stock in Regency while Statesman was cashed out. That these transactions occurred simultaneously rather than sequentially, the Court held, did not distinguish *Tri-Star* or *Rossette*, as "to do so would unjustly exalt form over substance in circumstances where the identical policy concerns that underlie *Tri-Star* and *Rossette* exist."

Gatz appears to extend *Tri-Star/Rossette* to transactions in which a third party, not the controlling stockholder, receives allegedly excessive shares. A recapitalization in which a controlling stockholder is cashed out and a third party receives a greater percentage of stock is open to direct claims under *Tri-Star/Rossette*. The facts of *Gatz* should nevertheless provide grounds to distinguish it in the future, such as when a controlling stockholder is not involved.

2007 AMENDMENTS TO THE DELAWARE CONSTITUTION TO ALLOW FOR CERTIFIED QUESTIONS OF LAW BY THE SEC AND TO THE GENERAL CORPORATION LAW OF THE STATE OF DELAWARE

Legislation amending Article IV, Section 11, paragraph 8 of the Delaware Constitution of 1897, as amended, to allow for the United States Securities and Exchange Commission (the "SEC") to certify questions of law to the Delaware Supreme Court has been approved by the Delaware General Assembly in two consecutive sessions and, therefore, has become effective. In addition, legislation amending the General Corporation Law of the State of Delaware (the "DGCL") has been adopted by the Delaware General Assembly and is expected to be signed by the Governor of the State of Delaware. The DGCL amendments, when signed by the Governor, will become effective August 1, 2007. The DGCL amendments are designed to keep Delaware law current and address issues raised by practitioners, the judiciary and legislators with respect to the current language or interpretation of the DGCL. The 2007 amendments to the Delaware Constitution and the DGCL are discussed below.

AMENDMENT TO CONSTITUTION

Article IV, Section II of the Delaware Constitution of 1897, as amended, sets forth the jurisdiction of the Supreme Court of the State of Delaware. Paragraph 8 thereof has been amended to add the SEC to the list of governmental bodies that may certify questions of law to the Supreme Court of the State of Delaware. This constitutional amendment represents a significant change in Delaware law by providing the SEC a ready means by which it can obtain an answer to a Delaware law question, without being left with no alternative other than to answer the question itself. As stockholder activism continues to be an unmistakable fact of today's corporate landscape, this amendment will provide a means to ensure that important questions of Delaware law continue to be determined by the Delaware Supreme Court.

AMENDMENTS TO THE DGCL

Board of Directors [§ 141]. Section 141 of the DGCL sets forth provisions relating to boards of directors of Delaware corporations. In 2005, Section 141(d) was amended to provide that the certificate of incorporation of a Delaware corporation could confer upon one or more directors voting power greater than or lesser than that of any other director, whether or not such director or directors were separately elected by the holders of any class or series of stock. The proposed amendment to Section 141(d) clarifies that, when a provision of the certificate of incorporation grants certain directors greater or lesser voting power than other directors, the differentiation of voting power applies both in voting by the board of directors and in voting by committees of the board and subcommittees, unless otherwise provided in the certificate of incorporation or bylaws.

Business Combinations with Interested Stockholders [§ 203]. Section 203 of the DGCL prohibits a corporation from engaging in any business combination with any interested stockholder for a period of three years following the time that the stockholder became an interested stockholder unless certain requirements are met. Section 203(b)(4) provides that the restrictions in Section 203 do not apply if the corporation does not have a class of voting stock that is (i) listed on a national securities exchange, (ii) authorized for quotation on The NASDAQ Stock Market, or (iii) held of record by more than 2,000 stockholders. The proposed amendment to Section 203(b)(4) eliminates the exception set forth in (ii) above. This revision is being made to accommodate ongoing changes in the structure and identification of securities trading markets, including recent changes in the configuration and status of securities trading markets.

Quorum and Required Vote for Stock Corporations [§ 216]. Section 216 of the DGCL governs stockholder quorum and voting requirements for Delaware stock corporations. Section 216(4) provides that where a separate vote by a class or series of stock is required, a majority of the outstanding shares shall constitute a quorum entitled to take action. The proposed amendment to Section 216(4) clarifies that, unless otherwise provided in the certificate of incorporation or the bylaws, a plurality vote (and not a majority of the quorum) is the vote required to elect directors where one or more classes or series of stock votes as a separate class or series for the election of directors.

Mergers and Consolidations. [§§ 251, 255 and 258]. Sections 251 and 255 of the DGCL set forth the statutory requirements for mergers or consolidations of domestic stock and nonstock corporations. The proposed amendments to Sections 251 and 255 eliminate the requirement that an agreement of merger or consolidation include a certification by the secretary or assistant secretary of the corporation that the agreement has been adopted by the requisite vote of the stockholders or members, as applicable, or otherwise has been approved in accordance with Section 251 without a vote of the stockholders, if a certificate of merger or consolidation is filed in lieu of filing the agreement. By virtue of the cross-references to Sections 251 and 255, this certification requirement for a Delaware corporation will also be eliminated from Sections 252, 254, 256, 257, 258, 263 and 264. Any certification required under other applicable law will not be affected by the proposed amendments to Sections 251 and 255.

Section 258(b) of the DGCL sets forth the method and procedure to be followed for mergers or consolidations of a domestic stock or nonstock corporation with a foreign stock or nonstock corporation. The proposed amendment to Section 258(b) clarifies that the agreement of merger or consolidation must also be certified by each of the constituent foreign corporations in accordance with the laws under which each was formed.

Appraisal Rights [§ 262]. Section 262 of the DGCL governs a stockholder's appraisal rights in connection with certain mergers and consolidations.

Section 262(b)(1) provides, in part, that appraisal rights are not available for shares of any class or series of stock which are "designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc." Similarly, Section 262(b)(2) provides, in part, that notwithstanding the provisions of Section 262(b)(1), appraisal rights are available in certain circumstances, including where holders of stock are required to accept for the stock anything except "[s]hares of stock of any corporation … designated as a national market system security on an interdealer quotation system by the National Association for Securities Dealers, Inc." The proposed amendments to Section 262(b) delete the phrase "designated as a national market system security on an interdealer quotation system by the National Association for Securities Dealers, Inc." Like the amendment to Section 203, the proposed amendments to Section 262 revise the specifications regarding the application of Section 262 and the availability of appraisal rights in order to accommodate ongoing changes in the structure and identification of securities trading markets, including recent changes in the configuration and status of securities trading markets.

Sections 262(e) and (k) of the DGCL govern the right of a stockholder who has demanded appraisal to file a petition in the Court of Chancery demanding a determination of the value of the stock of all such stockholders and the rights of a stockholder who has demanded appraisal to withdraw that demand and receive the merger consideration. The proposed amendments to Sections 262(e) and (k) clarify the right of a stockholder to withdraw an appraisal demand and receive the merger consideration at any time within 60 days after the effective date of the merger, even if a petition for appraisal has been filed, as long as that stockholder has not filed such a petition or otherwise joined the proceeding as a named party. Another proposed amendment to Section 262(e) enables beneficial holders of shares of stock held in street name to (i) file petitions for appraisal and (ii) request a statement of shares with respect to which demands for appraisal have been received, in their own name rather than in the name of the stockholder of record.

Sections 262(h) and (i) of the DGCL provide for the determination and payment of fair value of shares of stock in an appraisal proceeding, including the interest to be awarded in such proceedings. The proposed amendments to Sections 262(h) and (i) change the approach to awarding interest in appraisal proceedings, principally by establishing a presumption that interest is to be awarded for the period from the effective date of the merger until the date of payment of judgment, compounded quarterly and accruing at the rate of 5% over the Federal Reserve discount rate, giving effect to any variation in that rate during that period. The Court of Chancery may depart from this presumptive approach for good cause, in order, for example, to avoid an inequitable result such as rewarding, or insufficiently compensating for, improper delay of the proceeding or unreasonable or bad faith assertion of valuation claims. The proposed amendments to Section 262(h) also clarify that the Court of Chancery in appraisal proceedings does not determine the fair value of shares on its own initiative, and that appraisal proceedings are adversary proceedings to be litigated in accordance with generally applicable rules of the Court of Chancery.

* * *

The amendments to Sections 141(d), 216(4), 251, 255 and 258(b), when signed into law by the Governor of the State of Delaware, will be effective as of August 1, 2007. The amendments to Section 262, however, will be effective only with respect to transactions consummated pursuant to agreements entered into after August 1, 2007 (or, in the case of a short-form merger pursuant to Section 253 of the DGCL, consummated pursuant to resolutions of the board of directors adopted after August 1, 2007) and appraisal proceedings arising out of such transactions.