Unreported Cases

INTRODUCTION

UNREPORTED CASES is a continuing feature of THE DELAWARE JOURNAL OF CORPORATE LAW. Significant unreported cases that have not been published by a reporter system will be included. The courts' opinions are printed in their entirety, exactly as received.

To expedite the attorney's research, all cases are headnoted according to the NATIONAL REPORTER key number classification system.* Indices are provided for case names, statutes construed, rules of court, and key numbers and classifications for this issue.

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JAFFE v. REGENSBERG

No. 5965

Court of Chancery of the State of Delaware, New Castle

January 10, 1980

Proceeding instituted on motion of the individual defendants to dismiss for lack of personal jurisdiction and to quash service of process. The Court of Chancery, per Vice-Chancellor Brown, denied the motion of a nonresident defendant to dismiss for lack of *in personam* jurisdiction and to quash the service of process since the individual defendant consented to jurisdiction of court and service of process upon corporate agent by agreeing to serve as a director of corporation.

1. Corporations ⟹ 319

A nonresident defendant, by agreeing to serve as a director of a Delaware corporation, consents that service upon his statutory agent will amount to *in personam* jurisdiction over him as to any action filed in the courts of Delaware, arising out of his alleged violations of his duty as a director.

2. Dismissal & Nonsuit ⟹ 57

Where jurisdiction is sought by substituted service, statute requires an examination of the cause of action alleged against the nonresident director so as to weigh validity of *in personam* jurisdiction. DEL. CODE ANN. tit. 10, § 3114.

3. Corporations ⟹ 310, 110

An issuance of stock solely for the purpose of perpetuating or bringing about control is a breach of duties of a director.

4. Corporations ⟹ 316(3)

Where shares have been improperly issued to a director in breach of his duty to corporation, and where he is properly before the court as a party, such shares may be ordered cancelled as part of relief to be granted.

BROWN, *Vice Chancellor*

The original complaint in this action is based on the assertion that 534 shares of the common stock of the defendant Car-X Service Systems, Inc. ("Car-X") have been illegally issued to the defendant Aaron Regensberg, thus purporting to enable him, together with the defendant Petersen, to maintain majority control of the corporation and to thus elect a

majority of the Car-X board of directors under the cumulative voting procedures of the corporation. The problem arises from the fact that the corporation has authorized capital of 112,000 shares of common stock, but, with the issuance of the 534 shares to Regensberg together with the exercise of previously existing stock purchase options by others, a total of 112,500 shares have now been issued.

The complaint seeks the cancellation of the 534 shares which were issued to Regensberg as a result of action taken by the board of directors on March 15, 1979. The complaint further seeks a permanent injunction prohibiting the individual defendants from purporting to act as directors of Car-X, from attempting to transfer or vote the 534 shares alleged to have been improperly issued, and from otherwise interfering either with the action taken by those whom the plaintiffs view to be the true holders of the validly issued and outstanding stock of Car-X or with the business of Car-X. All such relief is sought on the basis that the individual defendants, all of whom were acting as directors of Car-X at the time, breached their duties as directors in issuing the 534 shares to Regensberg under the circumstances alleged. A declaratory judgment to this effect is also demanded.

None of the individual defendants are residents of Delaware. Service of process was made upon them under the provisions of 10 *Del. C.* § 3114. The individual defendants have moved to dismiss the complaint and to quash service of process as to them on the grounds that § 3114 is unconstitutional and that even if it is constitutional the defendants here are not amenable to service of process under its provisions.

As to the argument that the statute is unconstitutional, that point was addressed in the recent decision in *Pomerance v. Armstrong*, C.A. No. 5613 (July 17, 1979) and the validity of the statue was upheld. That decision is presently on appeal. For purposes of the present motion, however, the decision in *Pomerance v. Armstrong* is controlling in this Court, as the individual defendants concede, and consequently, to the extent that the present motion relies on the alleged unconstitutionality of § 3114, it will be denied.

[1] The major argument here is found in the second contention of the individual defendants. But here, too, their argument must fail. In essence, the defendants argue that the suit is in reality an action against Regensberg in his capacity as a shareholder of Car-X to bring about the cancellation of the 534 shares of stock issued to him as a result of the March 15, 1979 action of the board. It is argued that all other relief sought by the plaintiffs is predicated upon this cause of action against Regensberg as a shareholder. The individual defendants, including Regensberg, argue that they are not being sued in their capacities as directors, a contention they feel to be highlighted by the fact that no affirmative relief is sought against any of the individual directors other than Regensberg. They point out, however, that § 3114, by virtue of

its language and the explanatory synopsis attached to the legislation at the time it was enacted, makes it clear that the statute purports to effect personal jurisdiction over a nonresident director of a Delaware corporation only when he is being sued in his capacity as a director. They say that as a consequence it cannot be construed to effect personal jurisdiction over a nonresident who is being sued in his capacity as a shareholder simply because the nonresident also happened to hold office as a director at the time of the events giving rise to the complaint.

While this may be true as far as it goes, I am inclined to agree with the plaintiffs that such a rationale has no application here. The statute is a consent statute. It provides that a nonresident who accepts election or appointment as a director of a Delaware corporation thereby consents to the appointment of the corporation's registered agent or, if none, the Secretary of State, as his agent upon whom service of process may be made in any civil action brought against such director "for violation of his duty in such capacity, whether or not he continues to serve as such director" and acceptance or election as a director "shall be a signification of the consent of such director . . . that any process when so served shall be of the same legal force and validity as if served upon such director . . . within this State . . . ." 10 *Del. C.* § 3113(a).

This language makes it clear that by agreeing to serve as a director of a Delaware corporation, a nonresident consents that service upon his statutory agent will amount to *in personam* jurisdiction over him as to any action filed in the courts of this State arising out of his alleged violation of his duty as a director. This is so because actual personal service of process on a nonresident while in this State would constitute *in personam* jurisdiction over him, and by his acceptance of a directorship the nonresident agrees that service on the corporation's registered agent, or the Secretary of State, as to any such cause of action shall have the same effect. If a court has *in personam* jurisdiction over a person, then he is before the court for whatever judgment or relief the facts of the matter may require, be it an injunction, money damages, declaratory judgment, cancellation of stock, etc.

[2] I agree with the defendants that where jurisdiction is sought by substituted service of process under 10 *Del. C.* § 365 or 10 *Del. C.* § 366, the nature of the relief sought has a bearing on the method of service employed. For instance, sequestration (assuming necessary minimum contacts, of course) is available only where money damages are sought against a nonresident defendant. *Wightman v. San Francisco Bay Toll-Bridge Co.*, Del. Ch., 142 A. 783 (1928). Similarly, under § 3113 it is obviously necessary to consider the cause of action alleged because it is only as to suits by or on behalf of Delaware corporations as to which the nonresident directors are necessary parties, or as to actions charging them with a violation of their fiduciary duties, that the statute provides that acceptance of the office of director signifies consent to *in personam*

jurisdiction through service on the statutory agent. But there is a distinction, I feel, which the argument of the individual defendants tends to overlook, and it is simply this.

While the previously existing practice under § 365 and § 366 required an examination of the relief sought so as to weigh the propriety of *in rem* or *quasi in rem* jurisdiction, the language of § 3114 requires an examination of the cause of action alleged against the nonresident director so as to weigh the validity of *in personam* jurisdiction. Under § 3114, the relief sought is not the guiding factor because if jurisdiction attaches at all under the statute, the nonresident is before the Court for any and all relief that might be necessary to do justice between the parties by virtue of the fact that the jurisdiction conveyed by the statute is *in personam* jurisdiction.

To examine the cause of action here is to provide the answer to the defendants' motion. It is alleged, in essence, that acting in their capacities as the majority of the board of directors of Car-X on March 15, 1979 the individual defendants violated their duty as directors by authorizing the issuance of 534 shares of Car-X stock for no corporate purpose and for no reason other than to attempt to enable Regensberg and his associates to remain in control of Car-X, knowing full well at the time that if existing stock purchase agreements were exercised by other the issuance of the 534 shares to Regensberg would result in Car-X having issued 500 more shares of stock than authorized by its certificate of incorporation. The fact that the relief sought might work against one or more of the individual defendants in their personal capacities in order to rectify the situation does not detract from the theory of liability which activates the provision of § 3114.

If this were not so, then § 3114 would have indeed brought about an anomalous result. It would mean, if the defendants' argument was carried to its logical extreme, that jurisdiction could not be obtained over nonresident directors under § 3114 in any situation where the violation of their duty by the directors involved an illegal issue of stock to themselves for an inadequate consideration, for in such case it could be argued that they were really being sued as stockholders for a return of the stock and not as directors for a violation of their duty in wrongfully issuing it to themselves.

[3-4] Under Delaware law, an issuance of stock solely for the purpose of perpetuating or bringing about control has been held to constitute a breach of the duties of a director. *Condec Corp. v. Lunkenheimer,* Del. Ch., 230 A.2d 769 (1967); *Kors v. Carey,* Del. Ch., 158 A.2d 136 (1960); *Canada Southern Oils v. Manabi Exploration Co.,* Del. Ch., 96 A.2d 810 (1953). Where shares have been improperly issued to a director in breach of his duty to the corporation, and where he is properly before the court as a party, such shares may be ordered cancelled as part of the relief to be granted. *Maclary v. Pleasant Hills, Inc.,* Del. Ch.,

109 A.2d 830 (1954); *Cahall v. Burbage,* Del. Ch., 121 A. 646 (1923); 3 Fletcher, *Cyclopedia of Corporations* § 958 (perm. ed. rev. 1975).

The reliance of the individual defendants on Connecticut and North Carolina decisions, after whose statutes § 3114 was patterned, is also misplaced in view of the foregoing analysis. In both decisions it was held that no jurisdiction over the nonresident could be achieved under the statute. But, in *Goldfeld v. Wood Park Estates, Inc.,* Conn. Super., 281 A.2d 326 (1971), the suit was against the nonresident directors for their failure to honor an agreement to sell their stock to the plaintiff. Thus, the cause of action had nothing to do with their duties as directors. In *Lane Trucking Co. v. Haponski,* N.C. Supr., 133 S.E.2d 192 (1963), the cause of action was for conduct by the nonresident subsequent to his termination as a director. Both decisions seem clearly correct, but based on their facts they have no application here.

For these reasons, the motion of the individual defendants to dismiss and to quash service of process under § 3114 is denied. A form of order may be submitted.

AGENCY RENT-A-CAR, INC. v. GATEWAY INDUSTRIES, INC.

No. 6109

Court of Chancery of the State of Delaware, New Castle

July 21, 1980

Plaintiff, a stockholder of defendant, Gateway Industries, Inc., sought an order pursuant to provisions of DEL. CODE ANN. tit. 8, § 220, compelling defendant to comply with plaintiff's demand to be permitted to examine and copy a list of defendant corporation's stockholders and a plethora of books and records which plaintiff claims it must have in order to enable it to substantiate its suspicions of mismanagement, waste, and misappropriation of corporate assets on the part of certain members of Gateway's present management. The Court of Chancery, per Chancellor Marvel, held:

1. Plaintiff's request to inspect the stock list, ledger and "stock list documents" of the defendant was premature and contingent upon a finding of mismanagement, waste, or other corporate wrongdoing on the part of its management; and

2. Plaintiff's desire to investigate possible mismanagement is a proper purpose for inspecting corporate books and records and as such the plaintiff will be permitted such inspection. However, certain categories of information sought did not appear to be reasonably related to the suspicions

which caused the plaintiff to become concerned in the first place with the management of the corporation and, therefore, do not fall within the class of books and records which can be inspected.

1. Corporations ⟸ 399(1)

Actual authority of agent of corporation may consist of express authority granted agent either by stockholders, corporate charter, bylaws, or corporate action by stockholders or board of directors or it may amount to implied authority springing by necessary inference from those powers expressly granted to agent.

2. Corporations ⟸ 413

Person, who was corporation's president and chief-operating officer, had actual authority to make the formal demand for list of the defendant's stockholders and corporate books and records.

3. Corporations ⟸ 181(8)

Request for order demanding list of stockholders, ledger, "stock list documents," and certain books and records of corporation was not invalid in that no written authorization accompanied the demand expressly authorizing the corporate agent to make such demand since the requirements of DEL. CODE ANN. tit. 8, § 220, were fulfilled when the agent made demand under oath and had actual authority to make said demand.

4. Corporations ⟸ 181(1)

A proper purpose for inspection of a corporation stock list, ledger, and corporate books and records is investigation of possible mismanagement.

5. Corporations ⟸ 181(5)

Purpose required to be stated by stockholder in order to make demand for inspection of corporate books and records is "proper purpose" defined by statute as purpose reasonably related to demander's interest as stockholder. DEL. CODE ANN. tit. 8, § 220.

6. Corporations ⟸ 181(5)

Although the stockholder has a virtually absolute right to inspect a stock list of his corporation when such a stockholder has stated a proper purpose, such a stockholder is not entitled to inspection where purpose of the demand is premature and contingent upon a finding of mismanagement, waste, or other corporate wrongdoing on part of management.

7. Corporations ⟸ 181(2)

When stockholder establishes his status as such and seeks production of stock list and corporate books and records for purpose germane to that status, he is entitled to production of list and any secondary purpose of seeking list is irrelevant. DEL. CODE ANN. tit. 8, § 220.

8. Corporations ⟸ 181(8)

Where certain categories of information sought by plaintiff do not appear to be reasonably related to the proper purpose, such information does not fall within that class of corporate books and records which the plaintiff is entitled to inspect.

9. Pleadings ⟸ 237

A party may be permitted to amend a complaint to conform to the evidence, entitling it to add to its demands additional categories of information relevant to determination of corporate waste or mismanagement.

MARVEL, *Chancellor*

Plaintiff, a stockholder of the defendant Gateway Industries, Inc., seeks the granting of an order pursuant to the provisions of 8 Del. C. § 220 compelling defendant, which is a publicly-held corporation engaged in the manufacture of automobile seat belts, to comply with plaintiff's February 8, 1980 demand to be allowed to examine and copy a list of such corporation's stockholders and a plethora of books and records which plaintiff claims it must have in order to enable it to seek to substantiate its suspicions of mismanagement, waste and misappropriation of corporate assets on the part of certain members of Gateway's present management, Gateway having failed to respond to a demand for such documents within the statutorily fixed five-day period.

Agency, a closely held corporation engaged in the business of renting automobiles throughout the United States and parts of Canada, at the inception of this action held 81,800 shares of Gateway's common stock. Since then it has increased its holdings so that it presently holds approximately a 13% interest in Gateway. The latter, contending that the February 8, 1980 demand did not meet the technical requirements of 8 Del. C. § 220 and that in any event plaintiff is seeking such inspection for an improper purpose, vigorously opposes plaintiff's demand.

Agency became a Gateway shareholder on October 15, 1979 when it purchased a few hundred shares of such corporation's common stock for alleged investment purposes on the strength of the generally available financial information concerning such corporation's debt-equity ratio and dividend record. As Agency thereafter continued to purchase Gateway stock, Mr. Russell Smith, president and chief operating officer of plaintiff, and one of whose duties was to evaluate Agency's investments, decided to

investigate more thoroughly the Gateway investment. Accordingly, Mr. Smith obtained from the Securities and Exchange Commission a five-year dosier of Gateway's public disclosure statements, which dosier contained proxy statements, 10K forms and the like. After studying these documents Mr. Smith became concerned about certain business transactions and dealings between the corporation and its directors contained therein which appear to have been treated in a cursory manner. For example, while the public filings noted the sale by Gateway of its Chicago condominium, which had been carried on its books at $104,000, to Mr. Ganz, president of Gateway, for only $95,000.00, such reduction in cost being allegedly due to Gateway's renewal right to use said condominum for six months of the year over a three-year period, the public filings did not, however, indicate that the condominium had been appraised before the sale, or that the corporation's right to use the condominium was in fact being exercised. In like manner, while the public filings indicated that Mr. Ganz had sold his personal boat to the corporation, they failed to indicate whether or not an appraisal of such boat had been made prior to such sale. Mr. Smith's curiosity was also aroused by the disclosure of a $250,000 bonus paid to Mr. Ganz in 1975, a year in which he was being paid a salary of only $40,000. Such bonus had been given, according to the public filings, for past services rendered, however, the nature of such services was not disclosed. Furthermore, the 1975 filings state that in addition to receiving such bonus, that Mr. Ganz had in such year received a $96,000 loan from Gateway without disclosing the terms of such loan. The public filings also indicated that while during each year of such filings that certain moneys remained uncollected from a former officer of Gateway who had borrowed from Gateway, they did not mention any detailed efforts to collect such debt. Mr. Smith also questioned an incentive bonus plan innuring to the benefit of Mr. Ganz and of Mr. Frick and certain company policies concerning the use of company automobiles by certain employees. Mr. Smith was also concerned about the possibly excessive compensation being paid to Mr. Ganz, who had earned in the neighborhood of $50,000 a year from 1963 to 1975, inasmuch as the filings indicated that in 1976 his yearly salary had been increased to $270,757, in 1977 it was $390,844, in 1978 $371,958, and in 1979 $384,394. Concerned about such matters and the circumstances surrounding the adoption of a bonus plan and salary hikes, and wishing to become informed on whether or not appraisals, when needed, were being furnished by an independent committee, Mr. Smith arranged to meet with members of Gateway's management on February 7, 1980.

On January 28, 1980, Mr. Smith wrote defendant confirming the date for said meeting and outlined in said letter twenty seven areas of inquiry in which he was interested in obtaining additional information. Gateway, however, cancelled such scheduled meeting and curtly informed plaintiff that it was not entitled to the information it sought. Accordingly, a formal demand in writing for the desired documents was made on

February 8, 1980 for Gateway's stock list and enumerated documents, books and records, the stated purposes for such inspection being stated to be as follows:

> "The examination, inspection and copying of the stock list and documents described in categories 1 through 5 above is requested for the purpose of enabling the undersigned to communicate with other stockholders of Gateway on matters relating to their interest in Gateway, including, among other things, the desirability of changing the composition of the Board of Directors of Gateway.
>
> "The examination, inspection and copying of the books and records described in paragraphs (a) through (cc) above is demanded for the purpose of enabling Agency to investigate the affairs of Gateway, including, among other things, the possible mismanagement, waste, or misappropriation of the assets of Gateway."

To begin with, defendant contends that such February 8, 1980 demand fails to meet the requirements of 8 Del. C. § 220 in that said demand was not accompanied by a writing authorizing Mr. Smith to make such demand on behalf of his corporation and that Mr. Smith was not otherwise authorized to make such demand. Defendant further contends, that, in any event, the stated purposes for making such demand were insufficient as a matter of law.

The written demand for the inspection and copying of defendant's stock list and of designated books and records was made by Mr. Russell Smith, president and chief operating officer of Agency, in a letter dated February 8, 1980 addressed to Jerry Ganz, president of Gateway. The demand was attested by the assistant secretary of the plaintiff corporation and was sworn to by Smith before a notary public as follows:

> "On this 8th day of February, 1980, before me, personally appeared Russell Smith, known personally to me to be the President of the above-named corporation, and having first been duly sworn according to law did depose and say that he, as such officer, being authorized so to do, executed the foregoing instrument for the purposes therein contained, by signing the name of the corporation by himself as such officer, and that the statements made in the foregoing letter of demand are true."

8 Del. C. § 220(b) provides in pertinent part as follows:

> "In every instance where an attorney or other agent shall be the person who seeks the right to inspection, the demand under oath shall be accompanied by a power of attorney or such other

writing which authorizes the attorney or other agent to so act on behalf of the stockholder."

Defendant contends that the absence of a writing authorizing Mr. Smith to make the demand renders the February 8, 1980 letter ineffective, *Gay v. Cordon International Corp.*, Del. Ch. C.A. No. 5541, March 30, 1978, *Bear Stearns & Co. v. Pabst Brewing Co.*, Del. Ch., C.A. No. 5456, November 25, 1977, and *Petrick v. B-K Dynamics*, Del. Ch., 283 A.2d 696 (1971), which are cited for the proposition that the provisions of 8 Del. C. § 220 must be met, and that here plaintiff has failed to comply with the express terms of the statute.

Addressing a similar contention in the case of *Tannetics, Inc. v. A. J. Industries, Inc.*, Del. Ch., C.A. No. 4572, September 4, 1974, this Court held that such a demand made on behalf of a corporation by its president under oath need not necessarily be accompanied by a written authorization or resolution of the board of directors in order for the demand to comply with 8 Del. C. § 220 if in fact the officer of the corporation who made the demand had the authority to act on behalf of the corporation at the time of making the demand, the Court stating:

> "Defendant first attacks the sufficiency of plaintiff's demand, contending that Mr. Gerbach's authority to demand a list of A.J. stockholders should have been accompanied by a resolution of the board of directors of Tannetics, Inc. However, the statute does not require that a corporate resolution be furnished with a demand letter, and I am satisfied that Mr. Gerbach, whose demand was notarized, he having sworn under oath that he was chairman of the board and chief executive officer of Tannetics, Inc. '. . . and as such is authorized to make the above demand; that statements made in the above demand are true to the best of his knowledge and belief; and that the above demand is not made for any improper purpose.' *Stated such facts truthfully, the accuracy of his averments having been established at his deposition.*" (emphasis added).

[1-3] The evidence adduced at trial makes it clear that Mr. Smith had the authority to make the formal demand for the documents here sought, and while defendant attacks Agency's board of directors' resolution dated January 16, 1980, which purports to authorize Mr. Smith to make the demand here in issue, on the ground that two of the three directors on the board of Agency, namely Mr. Frankino's daughter and his elderly mother, while nominally serving as corporate directors, allegedly signed said resolution without being aware of its import, I am satisfied that such a resolution was redundant in light of the fact that Mr. Smith had in fact actual or implied authority to make such demand, *Petition of Mulco Products, Inc.*, Del. Super., 123 A.2d 95 (1956).

Mr. Smith testified he had actual authority to make such demand by virtue of his office as president and chief operating officer, and Mr. Sam Frankino, chairman of the board and the sole stockholder of Agency, also testified that Mr. Smith had such authority. I conclude that the fact that no written authorization accompanied the February 8, 1980 demand expressly authorizing Mr. Smith to make such demand does not mean that plaintiff did not fulfill the requirements of 8 Del. C. § 220, Mr. Smith having made such demand under oath and having implied if not express authority to make said demand.

[4-5] Defendant also contends that in any event the February 8, 1980 letter does not comply with the provisions of 8 Del. C. § 220 because the stated purposes therein are insufficient as a matter of law, or in other words, the demand does not set forth a proper purpose for the inspection of Gateway's stock list or ledger or corporate books and records.

It is well settled that a desire to investigate possible mismanagement is a proper purpose for inspecting books and records, *Skouras v. Admiralty Enterprises, Inc.*, Del. Ch., 386 A.2d 674, 678 (1978), *Nodana Petroleum Corporation v. State*, Del. Supr., 123 A.2d 243 (1956), *Sack v. Cadence Industries Corporation*, Del. Ch., C.A. 4765 (April 7, 1975), and *Henshaw v. American Cement Corporation*, Del. Ch., 252 A.2d 125 (1969). Furthermore with regard to plaintiff's stated purpose for seeking inspection of defendant's stock list, namely for the purpose of "enabling . . . [Agency] to communicate with other stockholders of Gateway on . . . the desirability of changing the Board of Directors of Gateway," I am satisfied that such demand, sufficiently apprised Gateway of the nature of its purpose, namely the desirability of changing the composition of the board of directors of Gateway in the event plaintiff should succeed in substantiating its fears as to suspected corporate mismanagement, a stated purpose which, I believe, meets the test of *Northwest Industries, Inc. v. B.F. Goodrich Company*, Del. Supr., 260 A.2d 428, 429 (1969). Compare contra *Weisman v. Western Pacific Industries, Inc.*, Del. Ch., 344 A.2d 267 (1975) wherein an unspecific demand could not be given an expanded reading. I conclude that plaintiff has met with the requirements of 8 Del. C. § 220 for making the demands it has made for a stock list and for books and records of Gateway.

[6] But while the provisions of 8 Del. C. § 220 give to a stockholder a virtually absolue right of inspection of a stock list of his corporation when such a stockholder has stated a proper purpose, namely one reasonably related to his status as a stockholder, by placing the burden of proving an improper purpose for seeking such inspection upon the party resisting the demand,[1] plaintiff, in my opinion, is not now entitled to

1. In the case of a stockholder demanding inspection of the corporation's stock ledger or list of stockholders, 8 Del. C. § 220(c) provides that

". . . the burden of proof shall be upon the corporation to establish that the inspection he seeks is for an improper purpose."

inspect the stock list, ledger and "stock list documents" [2] requested inasmuch as it clearly appears from a reading of the stated purpose, considered in light of the evidence adduced at trial, that Agency's need to communicate with other shareholders concerning the desirability of changing the personnel of the board of directors of Gateway is contingent upon a finding of mismanagement, waste or other corporate wrongdoing on the part of its management. See *Schluter v. Merritt Chapman & Scott,* Del. Ch., C.A. 4828, October 17, 1975, a case which holds that a plaintiff stockholder is not entitled to inspect his company's stock list and ledger, where it is apparent that there would be no reason to communicate with other shareholders were plaintiff to find, after inspecting such corporation's books and records, that there was in fact no showing of excessive compensation being paid to certain directors and officers of defendant or other wrongdoing on the part of corporate management. In other words, the demand by Agency for inspection of the stock list and ledger, as in the Schluter case, is premature at the present time.

[7] Turning to plaintiff's demand to inspect and copy books and records of Gateway, I am persuaded, however, that Agency, in seeking such inspection, is not primarily motivated by a wish on plaintiff's part merely to harass Gateway into forming some sort of improper business combination, as hinted by defendant. And while Agency's mounting acquisition of stock of Gateway may in the future raise an inference that plaintiff intends improperly to acquire control of Gateway, such secondary purpose is irrelevant where plaintiff is now clearly motivated by a proper purpose, *Skouras v. Admiralty Enterprises, Inc., supra, Western Air Lines, Inc. v. Kekorian,* Del. Supr., 254 A.2d 240 (1969), *General Time Corporation v. Talley Industries, Inc.,* Del. Supr., 240 A.2d 755 (1968), and *Skoglund v. Ormand Industries, Inc.,* Del. Ch. 372 A.2d 204 (1976). Moreover Gateway has not shown that the granting of the inspection would be injurious to the best interests of Gateway. The evidence [3] adduced at trial not only tends to substantiate Agency's suspicions

2. While plaintiff has collectively denominated certain information, namely lists of option holders, stop orders and brokerage breakdowns, as "stock list documents" and attempts, apparently, to equate its right of inspection with regard to said information with its right to inspect Gateway's stock list and ledger, in my opinion such information is more properly includable within the "books and records" category such that plaintiff must show a proper purpose for inspecting same. There having been no evidence or factual basis presented to indicate any wrongdoing by Gateway with regard to these documents, plaintiff is not entitled to inspect same. Thus, inspection of document categories 3-5 as well as 1 and 2 (list and ledger) is denied as being beyond the scope of plaintiff's inquiry into mismanagement of Gateway.

3. In reaching the results here stated, I have not relied on certain investigative reports commissioned by plaintiff [Spinelle Reports] as evidence of wrongdoing. These reports were not made until after the February 8, 1980 demand and the interviews upon which said reports were based were not conducted until some time after that date. Thus, the reports are not admissible on the "state of mind" exception to the hearsay rule as they could not have a bearing on Mr. Smith's state of mind in making the February 8, 1980 demand. Accordingly, I will grant defendant's motion to strike the reports and references thereto appearing in the briefs and testimony.

of wrongdoing aroused by an examination of Gateway's public filings as well as the latter's subsequent reluctance to discuss such subjects, but also disclose other incidents of waste and corporate mismanagement ranging from the improper use of corporate credit cards for personal purchases by Mr. Ganz to improper expenditures of corporate monies for female companionship.

[8] While plaintiff will accordingly be permitted to inspect and copy books and records bearing on a wide range of allegations of corporate mismanegement, certain categories of information sought by it do not appear to be reasonably related to the suspicions which caused Agency to become concerned in the first place with the management of Gateway and therefore do not fall within that class of books and records which plaintiff is entitled to inspect, *Skoglund v. Ormand Industries, Inc., supra.* Accordingly, there being an insufficient showing of a basis for misgivings concerning Gateway's Mexican subsidiary, Agency will not be allowed to inspect those categories of books and records concerning such subsidiary (listed in the complaint as 9, 29, 30, 31, 32, and 33). In like manner, I conclude that Agency is not entitled to inspect those books and records concerning the number of its treasury shares held by Gateway as well as the number of its own shares acquired by such corporation between December 31, 1979 and February 8, 1980 (categories listed in the complaint as 7 and 8), said information admittedly having been sought for another purpose, namely to enable Agency to comply with certain filing requirements. However, inasmuch as at the conclusion of the recent annual meeting of its stockholders, Gateway furnished plaintiff with a copy of its bylaws as well as a copy of its incentive bonus plan, there is no need to consider Agency's inspection right as to these documents (listed in the complaint as 6 and 10). It follows that defendant must produce all other records sought in plaintiff's demand.

[9] Next, I shall permit Agency to amend its complaint to conform to the evidence, thereby entitling it to add to its demand three additional categories of information which I believe are relevant to a determination of whether or not there has been, in fact, a waste of corporate assets as well as other acts of mismanagement. As a result Gateway shall also be required to permit inspection by Agency of books and records concerning gifts made by Gateway as well as those records which reflect the existence and maintenance by Gateway of a confidential payroll since January 1, 1976. Finally, Gateway will be required to produce for inspection and copying those records which relate to Gateway vehicles which have been sold to or made available to employees of Gateway and their families or to persons not employed by Gateway, since January 1, 1976.

An appropriate form of order may be presented on notice.

BUNNELL PLASTICS, INC. v. GAMBLE

No. 5913

Court of Chancery of the State of Delaware, New Castle

September 24, 1980

Action by employer against former employee for an injunction restraining ex-employee from violating restrictive business covenant contained in the employment agreement. Plaintiff also seeks accounting and damages.

The Court of Chancery, per Chancellor Marvel, held that the covenant sought to be enforced was reasonable under the circumstances and should be given force and effect. An injunction was issued to enjoin the continuing breach of the employment contract, but the question of damages, if any, will be submitted to a jury.

1. Contracts ⟸ 117(1)

Restrictive covenant prohibiting employee from competing with employer for two years after termination of employment will be given effect to the extent that it is reasonable.

2. Contracts ⟸ 117

A covenant not to compete will generally be found to be reasonable if it protects the legitimate interests of the employer, imposes no undue hardship on the employee and is not injurious to the public.

3. Master & Servant ⟸ 60

A "trade secret" may consist of a formula, process, device, or compilation which one uses in his business and which gives him an opportunity to obtain an advantage over competitors who either do not know or do not use it.

4. Master & Servant ⟸ 60

Factors to be considered when establishing the existence of a trade secret include the element of secrecy itself, the extent to which the alleged secret is known to others involved in the same general business, the effort and money expended in the development of the alleged secret, and the ease of its duplication by others.

5. Contracts ⟸ 117

A covenant designed to protect a bona fide trade secret will be sustained if not unreasonably broad not only as to territory and time but also as to the subject matter of the covenant itself.

6. Contracts ⟸ 169

Covenants not to compete are to be construed in accordance with what the parties intended at the time that a contract was signed, viewed in light of the surrounding facts and circumstances.

7. Injunctions ⟸ 61(2)

Where employee violated covenant not to engage in a rival business after termination of employment, and where the services of the employee have been such that he acquired knowledge of employer's business methods and secrets, and disclosure of which will result in irreparable injury to the employer, an injunction will issue.

8. Equity ⟸ 378

In a suit by employer for breach of restrictive covenant not to engage in a competitive business, where the damages are clearly unliquidated, it would be appropriate for such damages to be framed for submission to a jury.

MARVEL, *Chancellor*

Plaintiff Bunnell Plastics, Inc. seeks the granting of permanent injunctive relief against alleged violations by the defendant Gamble of a covenant on his part not to compete with plaintiff after termination of his employment as provided for in an employment contract designed to protect plaintiff's alleged trade secrets, entered into between plaintiff and the defendant Gamble in the autumn of 1975. Also sought by plaintiff is an accounting from the defendants Gamble and Innovations Engineering, Inc., for damages allegedly resulting from the injuries claimed to have been suffered by plaintiff as a result of alleged violations of the aforesaid covenant as well as other alleged acts of unlawful and unfair competitive action on the part of both defendants in the area of providing roll coatings and insulators for the ends of dryer rolls in the pulp and paper industry.

Prior to reporting for work at Bunnell in the fall of 1975, the defendant Gamble executed an employment agreement, as noted above, under the terms of which the latter not only agreed to assign to plaintiff any new processes developed by him in the course of his employment, whether patentable or not but also specifically agreed not to compete with plaintiff's business in the area of roll coatings for a period of two years following termination of his employment by plaintiff. I am satisfied that Mr. Gamble fully understood and appreciated the import of such agreement, having in the past signed a similar employee agreement with his former employer, Fluorodynamics, Inc.

Bunnell Plastics began its present business operations in 1964 principally in the field of plastic extrusions, becoming eventually involved in the manufacture of both extruded plastic sleeves and coatings, each of which was designed to be applied to the outside of rolls used in the pulp and paper manufacturing business. In entering plaintiff's employ, Mr. Gamble also agreed to divest himself of his interest in his own competitive corporation, namely First State Industrial Sales Corporation. However, Mr. Gamble, at the inception of his employment by Bunnell, managed to minimize the impact of his agreement not to compete with his employer by seeking and obtaining leave to exclude from such agreement his claimed interest in a formula for a non-stick roll coating and the use of a mailing list of customers of his corporation, the defendant First State Industrial Sales, from the provisions of paragraphs 3 and 4 of the employee agreement. A description of such coating having been furnished to Bunnell, its basic substance proved to be Epo-Tec 360. At the beginning of Mr. Gamble's employment by Bunnell, such employer requested and was furnished a letter from First State, which reported that Mr. Gamble was no longer associated with it. However, it appears that not only did Mr. Gamble not dispose of his First State stock, as agreed to, but, in fact, ultimately became the sole stockholder of such corporation, remaining in a managerial position at First State during the period of his employment by Bunnell. Mr. Gamble having had previous experience in the pulp and paper industry, on becoming an employee of Bunnell, became involved in manufacturing plastic sleeves and coatings to be applied to the outside of rolls in Bunnell's pulp and paper business.

Mr. Gamble's duties with Bunnell included the responsibility for directing the sales of chemical products, aiding in the development of such products as well as researching the development of possible new products. In the meantime, in the fall of 1976, Mr. Gamble had become the sole employee of Corcon (a former subsidiary of Bunnell which had been merged into Bunnell following Mr. Gamble's employment by Bunnell) and was entrusted with the developing and marketing of coatings through sales representatives who were required to report directly to him. He first experimented with his Epo-Tec 360 formula, but testing having demonstrated that it was unsuitable as a coating, it was ultimately rejected. Following discussions with Midland-Dexter in which Bunnell's staff reported on the release factor and other properties required for the coating required, a coating which proved acceptable was developed, which was then marketed by Corcon as its C78-2 black coating. The first apparently successful application of this material by Corcon was accomplished at Bowater in December, 1977, but the application proved to be unsatisfactory. Thereafter, the services of a company by the name of Broyles Refinishers were enlisted, and, in the summer of 1978, Bunnell and Corcon were able to apply such coating in a successful manner.

During this period, Mr. Gamble had arranged for the hiring of a new president for First State, obtained new financial books for such cor-

poration and had its name changed to Innovations Engineering, Inc. In addition, he approached all of Bunnell's sales representatives, and by early 1979 had either signed exclusive contracts for marketing Innovations' products with such persons or had solicited customers for such corporation. It also appears that during this period Mr. Gamble attended a number of sales' conferences, ostensibly as an agent of Bunnell, but actually acting in the interest of his own corporation.

Plaintiff further claims that while an employee of Bunnell, Mr. Gamble breached the employee agreement in issue by giving out information acquired while he worked for Bunnell to Innovations. It is further claimed that during working hours at Bunnell, Mr. Gamble allegedly misrepresented that the Bunnell coatings were the work product of Innovations Engineering and at the same time caused the expenses incurred in the furtherance of the latter's business to be charged to and collected from Bunnell.

During his period of employment by Bunnell, Mr. Gamble also approached his employer with an idea he had developed concerning dryer end insulators. However, he did not divulge such idea to his employer, and in September 1978 filed an application on his own behalf for the issuance of a patent for such an insulator. Plaintiff contends that under the terms of the employment agreement that it is entitled to an assignment to it of such patent.

In April 1979, Bunnell first learned of Mr. Gamble's continuing business connection with Innovations Engineering, and, after investigation, Mr. Gamble was informed that Bunnell considered his actions to be in violation of the employee agreement. Mr. Gamble was thereafter discharged as an employee of Bunnell.

Defendants contend that during the period of Mr. Gamble's employment by Bunnell, the latter owned no trade secrets or unique processes entitled to protection and that plaintiff therefore is not entitled to an injunction barring him from using the general knowledge acquired by him while an employee of Bunnell in the management of his own pulp and paper business; that the idea of roll coatings was specifically excluded from the ambit of the employee agreement and that Bunnell accordingly has no proprietary rights in roll coatings or insulators, and that Mr. Gamble and Innovations Engineering have accordingly not engaged in any unfair competition with plaintiff which would entitle plaintiff to injunctive relief or damages.

The validity and enforceability of a covenant not to compete is governed by the law of the place where the contract containing such a covenant was made, *Award Incentives, Inc. v. Van Rooyen,* 263 F.2d 173 (CA3, N.J. 1959). The contract here in issue was not only made in New Jersey, but was also to be performed in that State. Accordingly, New Jersey law clearly applies.

The covenant not to compete appears in the employee agreement as paragraph 8 and reads as follows:

> "I recognize that as a result of my employment by BP I will be exposed to BP's trade secrets and practices, including, but not limited to, manufacturing techniques, products, research, and customer lists. In recognition of the significance of the aforementioned, I agree that for a period of two (2) years after the termination of my employment by BP, anywhere in the continental United States, I will not directly or indirectly, own, manage, operate, control, participate in, or be connected in any manner with the ownership, management, operation or control of any business similar to the type of business then conducted, or activity contemplated, by BP at the time of the termination of my employment. I understand that any violation of the agreement made herein would result in irreparable harm to BP necessitating, in addition to other remedies, immediate injunctive relief."

[1-2] As a general rule, a provision in an employment contract prohibiting an employee from competing with his former employer following termination of employment will be given effect to the extent it is reasonable. See *Solari Industries, Inc. v. Malady,* 55 N.J. 571, 264 A.2d 53 (1970) in which it is held that it will generally be found to be reasonable if it . . . simply protects the legitimate interests of the employer, imposes no undue hardship on the employee and it is not injurious to the public." Legitimate employer interests do not include preventing competition per se, the free enterprise system favoring competition, Blake, *Employee Agreements Not to Compete,* 73 Harv. L. Rev. 624, 652 (1960), and *Whitmyer Bros. Inc. v. Doyle,* N.J. Supr., 274 A.2d 577 (1971). However, the employer does, as noted in the cited case have a ". . . patently legitimate interest in protecting his trade secrets as well as his confidential business information. . . ."

[3-4] In the case at bar, the dispute between the litigants centers around the art of applying roll coatings in the pulp and paper industry, plaintiff contending that the coating marketed as Corcon C78-2 for application to rolls, as developed during Mr. Gamble's employment by plaintiff, is a trade secret, while the defendant Gamble contends that such coatings in issue are not secret formulas but rather readily available commercial products, which can be purchased off the shelf, thus ignoring the need to experiment with such material. In the case of *Sun Dial Corporation v. Rideout,* N.J. Supr., 108 A.2d 442, 445 (1954) the Court noted that a ". . . trade secret may consist of a formula, process, device or compilation which one uses in his business and which gives him an opportunity to obtain an advantage over competitors who do not know or use it." Additional factors to be considered in establishing the existence of a trade secret include the element of secrecy itself, the extent to which the alleged secret is known to others involved in the same general business,

the effort and money expended in the development of the alleged secret, and the ease of its duplication by others. See 4 *Restatement, Torts* § 757, p. 5-6 (1939). The facts of record here indicate that the development of the coating here in issue involved experimentation over a period of at least one year until acceptable release levels were obtained, while an additional six months of testing were required until such coating could be successfully applied on a commercial basis. Furthermore, the development of such process involved a substantial investment of money by Bunnell. In addition, secrecy was sought to be preserved by such acts as the removal of labels on all containers in which the coating material was stored and the replacing of such labels with coded Bunnell labels so as to prevent discovery of their contents. The fact that the coating in issue was being purchased from a commercial supplier does not preclude its specialized use from being a trade secret, the alleged secret being found in the fact that the compound in issue was apparently for the first time being used as a roll coating, thus giving Bunnell an advantage over competitors in the industry who did not know of such material's full capabilities, *Sun Dial Corporation v. Rideout, supra.* In light of the foregoing, I am of the opinion that the use of the Corcon C78-2 composition in the manner here evolved through trial and error became a trade secret within the protection of the covenant here in issue.

[5] In order to warrant the enforcement by injunction of a covenant made by a former employee not to compete with his employer, such covenant must be weighed in light of the surrounding facts and circumstances, protection of trade secrets having long been recognized as a legitimate interest of an employer, *Sun Dial Corp. v. Rideout, supra.* Accordingly, a covenant designed to protect a bona fide trade secret will be sustained if not unreasonably broad not only as to territory and time but also as to the subject matter of the covenant itself. Defendants, while not directly attacking the territorial and time periods of the covenant here in issue, namely the continental United States for a period of two years, do contend, however, that the covenant here in issue is unreasonably broad viewed in light of the nature of the material sought to be protected, *Hudson Foam Latex Products, Inc. v. Aiken,* N.J. Super., 198 A.2d 136 (1964). In the cited case, the Court held to be unreasonable a provision prohibiting a former employee from divulging, in addition to the basic secret information sought to be protected, ". . . any other information of whatever kind or nature, obtained by him in the course of employment" or making ". . . any use of such information except for and on behalf of the employer." In the present case, however, the restriction found in paragraph 1 of the employment agreement is expressly concerned with the disclosure of ". . . any confidential information or any other material relating to the business or operation of B.P." Unlike the broad restriction found in the case of *Hudson Foam Latex Products, Inc. v. Aiken, supra,* such provision does not prohibit Mr. Gamble from using the gen-

eral knowledge acquired by him in the course of his employment by Bunnell. Such covenant also is much more narrow as to the nature of the information it seeks to control, being concerned only with the protection of "confidential information" or "material relating to the business or operation of B.P." as opposed to "any other information of whatever kind or nature."

I conclude that the covenant here sought to be enforced is reasonable under the circumstances and should be given force and effect. Compare *Chas. S. Wood & Co. v. Kane,* 42 N.J. Super. 122, 125 A.2d 872 (App. Div. 1956).

Defendants go on to contend that, in any event, Mr. Gamble has not breached the employment agreement in issue, arguing that the concept of roll coatings does not fall within the terms of paragraph 3 of the employee agreement and furthermore that it was specifically excluded from the agreement by paragraph 7 of such agreement.

Paragraph 3 of the agreement provides:

> "I hereby assign to BP all my rights, title, and interest in any invention or idea, patentable or not, made or conceived solely or jointly by me: (a) at any time during my employment with BP in any capacity; (b) which relates, directly or indirectly, to the actual or anticipated research or development by BP or any of its subsidiaries, or is suggested by or results from any facet of my immediate work responsibility, or work performed by me for or on behalf of BP."

Paragraph 7 stipulates that any inventions or ideas not encompassed in paragraph 3 of the agreement have been listed and described at the end of the employee agreement. A footnote on the first page of such agreement states:

> "Under this Agreement, it is in your interest to indicate and verify that any inventions or idea encompassed by Paragraph 7 were made or conceived prior to your employment by BP. Paragraph 7 does not require that you disclose such inventions or ideas in detail, merely identify them by titles and dates of documents, if any, describing them. Should you wish to interest BP at any time in such inventions, and ideas you may submit them, in writing, to BP for consideration."

The only invention or idea so submitted by Mr. Gamble was for a "Non-stick Roll Coating," the date on such document being 2/20/74. However, no document dated 2/20/74 was produced by him. Indeed, a document dated 10/15/75, describing a "Non-stick Roller Coating" was submitted by Mr. Gamble and filed with the employee agreement.

[6] Covenants not to compete are to be construed in accordance with what the parties intended at the time that a contract was signed viewed in

light of the surrounding facts and circumstances, *Tull v. Turek,* Del. Supr., 147 A.2d 658, 661 (1958). In the Court's opinion, the facts of this case establish that the invention or idea which Mr. Gamble intended to protect was the formula contained in the document dated 10/15/75 filed with the employee agreement, a formula which was subsequently found to be ineffective for the use intended and was in fact later abandoned.

Defendants nonetheless argue that the basic idea of roll coatings should be excluded from the agreement, it being conceded that paper rolls have been coated with teflon and other similar materials for up to twenty years and more. However, in the case at bar a description of the roll coating relied on by Mr. Gamble as his own conception was requested by Bunnell as part of the parties' agreement. In light of these facts the Court must reject the contention urged by the defendant Gamble, namely that all roll coatings were to be excluded from the employee agreement. Accordingly, the results of any work accomplished for the development of a successful roll coating subsequent to the abandonment of Mr. Gamble's original formula belong to Bunnell pursuant to the provisions of paragraph 3 of the employee agreement. Thus, Mr. Gamble's actions, in appropriating as his own, the improvements pertaining to roll coatings, which were developed during his employment by Bunnell, constituted a breach of his employee agreement and Bunnell is accordingly entitled to an assignment by defendants of all right, title and interest in the roll coating formula presently being marketed by the defendant corporation.

Defendants further contend that Bunnell has no valid claim to rights under the employee agreement to Mr. Gamble's concept of dryer insulators. In my opinion, however, Mr. Gamble, by voluntarily entering into the employee agreement, parted with all of his rights in any idea which he might thereafter develop whether patentable or not, when he executed the assignment contained in the employee agreement. *See Misani v. Ortho Pharmaceutical Corp.,* N.J. Super., 198 A.2d 791, *reversed on other grounds,* N.J. Supr., 210 A.2d 609, *cert. denied,* 382 U.S. 203, 15 L. Ed. 2d 270, *rehearing denied,* 384 U.S. 923, 16 L. Ed. 2d 499 (1966). Paragraph 3 states, in pertinent part, that:

> "I hereby assign to B.P. all my rights, title and interest in any invention or idea, patentable or not, made or conceived solely or jointly by me:
>
> * * *
>
> "b. Which . . . is suggested by or results from any facet of my immediate work responsibility, or work performed by me for or on behalf of B.P."

Defendants argue, however, that since Bunnell evidenced no interest in and took no action with regard to insulators during the period of the

Gamble employment, it thus freed Mr. Gamble from his duty to assign his ideas in such area developed during his employment by Bunnell. Such a modification of the contract, however, requires the mutual assent of the parties, 17 *Am. Jur. 2d Contracts* § 465, which the Court finds lacking in this case. Therefore, Mr. Gamble's rights and interest in the dryer end insulators must be assigned to Bunnell as provided for in the employee agreement.

[7] Inasmuch as an injunction will issue to enjoin the continuing breach of an employment contract not to engage in a rival business after termination of employment where the services of the employee have been such that he acquired knowledge of the employer's business methods and secrets, disclosure of which will result in irreparable injury to the employer, it follows that such an injunction must issue here. *Ideal Laundry Co. v. Gugliemone,* 107 N.J. Eq. 108, 151 A. 617 (1930); *Irvington Varnish & Insulator Co. v. Van Nordc, supra,* and 43A *C.J.S. Injunctions* § 95.

In short, plaintiff, which appears to have been extraordinarily naive concerning the disloyalty of the defendant Gamble, has established by the preponderance of the evidence a showing of irreparable injury as a result of defendants' actions and consequently has established its right to permanent injunctive relief against the continued competition by defendants with plaintiff through use of plaintiff's trade secrets for a period of two years from the date of Mr. Gamble's termination of employment, namely until April 18, 1981. Defendants' contention that the granting of such an injunction will work an undue hardship on them is not persuasive. "The discretion exercised by courts of equity in refusing injunctions on the ground of greater injury to the defendant, is properly restricted to applications pendente lite." *Simmons v. City of Patterson,* 60 N.J. Eq. 385, 45 A. 995 (1900) and *Port of New York Authority v. City of Newark,* 17 N.J. Super. 328, 85 A.2d 815 (1952). Where it is demonstrated that irreparable injury will continue to be suffered by a plaintiff as a result of a defendant's conduct after final hearing unless enjoined, permanent injunctive relief, regardless of the ensuing injury to the defendant, is nonetheless appropriate, *Port of New York Authority v. City of Newark, supra.*

[8] Turning to the question of damages allegedly sustained by plaintiff as a result of the breach of the covenant here in issue, I am satisfied that because the damages, if any, suffered by plaintiff as a result of the breach here established are clearly unliquidated that it would be more appropriate for such amount of damages to be determined in the first instance by a jury at the bar of the Superior Court then by a single judge sitting in this Court, and that the issue as to claimed damages to be so decided should be framed for submission to such a jury, *Scotton v. Wright,* 13 Del. Ch. 214, 117 A. 131, *aff'd* 13 Del. Ch. 402, 121 A. 69 (1923).

Finally, defendants having submitted no evidence in support of their counterclaim, it will be dismissed.

On notice, a form of order in conformity with the above may be submitted.

FISHER v. SMITH

No. 4531

Court of Chancery of the State of Delaware, Sussex

September 30, 1980

Derivative action against fifty percent shareholder director who had purchased restaurant owned by corporation at a foreclosure sale at just above half its fair market value. In granting respondent shareholder's motion for summary judgment, the Court of Chancery, per Vice-Chancellor Brown, held that respondent's purchase of restaurant did not violate any fiduciary duty since no one had bid more than him and corporation was unable to pay the mortgage.

1. Corporations ⇐ 312(6)

Price which is more than half the value of land at a foreclosure is not so shockingly low as to set aside sale where the land is purchased by a fifty percent shareholder of selling corporation.

2. Corporations ⇐ 312(6)

Fifty percent shareholder owes no fiduciary duty to corporation to bid the fair market value of the land at a sheriff's sale.

3. Corporations ⇐ 312(6)

A fifty percent shareholder owes no fiduciary duty to bail the corporation out of all its debt simply because another corporate entity of which he is a controlling shareholder is able to acquire the debt held by third parties against the corporation which the corporation itself was unable to pay.

BROWN, *Vice-Chancellor*

In this alleged derivative action, both sides have moved for summary judgment, the motion of the plaintiff, however, being one for partial sum-

mary judgment on the issue of liability only. The case was filed more than six years ago.

The undisputed facts reveal that the plaintiff Fisher and the defendant A. Gray Magness are the two shareholders of MF Construction Co., each owning 50 per cent of the outstanding shares. MF Construction Co. was originally in the building and construction business. It ended up owning a restaurant property near Glasgow. The restaurant property had been acquired by means of a purchase money mortgage given to the previous owners. Eventually the mortgage became in default and the corporation had no funds with which to pay it. Efforts were made to obtain financing, but they proved unsuccessful. The mortgagees commenced foreclosure proceedings and obtained a judgment against the corporation on the mortgage debt.

The defendant Magness is also an officer and 80 percent shareholder of the defendant Magness Construction Co. That corporation already held a judgment against MF Construction Co. in excess of $12,000. With a mortgage foreclosure sale appearing imminent, Magness Construction Co. purchased the mortgage judgment and obligation from the purchase money mortgagees. During the ensuing six months, no action was taken by Magness Construction Co. During this period, both Magness Construction Co. and Magness were amenable to a private sale of the restaurant property provided a buyer could be found. Apparently there were no takers. During this period also the defendant Magness was willing, as 50 per cent shareholder of MF Construction Co., to advance one-half of the funds necessary to enable the corporation to pay off its obligations, provided that the plaintiff Fisher, as the other 50 per cent shareholder, was willing to do likewise. Fisher was apparently either unwilling or unable to do so.

As a result, Magness Construction Co. later went forward with the foreclosure proceedings and thereby caused the restaurant property to be sold at Sheriff's sale. At this sale, Magness Construction Co. was the high bidder at $65,000. It had paid in excess of $50,000 to acquire the mortgage, and in addition it held the judgment previously mentioned.

[1] Plaintiff challenged the confirmation of the Sheriff's sale in the Superior Court, claiming the price to be inadequate. A hearing was held on that issue. At the hearing, plaintiff offered testimony to show the value of the real estate to be in excess of $130,000. An expert called by Magness Construction Co. placed a value of $98,000 on it. It was the decision of the Superior Court that on the evidence presented, the price of $65,000 was more than half the value of the property and that as a consequence it was not so shockingly low as to warrant setting aside the sale. Accordingly, the purchase of the property by Magness Construction Co. was confirmed. Later, Magness Construction Co. sold the property to a third party for a price slightly in excess of $74,000.

[2] On these facts plaintiff charges that Magness, acting through Magness Construction Co. which he controlled, violated a fiduciary duty that he owed to MF Construction Co., by purchasing for $65,000 property owned by the corporation which his own expert valued at $98,000. In other words, as I understand it, it is plaintiff's position that Magness, through Magness Construction Co., had a fiduciary duty to bid at least $98,000 at the Sheriff's sale even though no one else was willing to bid as much as $65,000, and that as a consequence Magness is indebted to the corporation for the difference of $33,000. (This argument ignores the likelihood that to have done so might well have spawned a derivative suit by the minority shareholders of Magness Construction Co.). On the undisputed facts, I do not feel this argument to have merit.

Plaintiff relies on *Guth v. Loft, Inc.,* Del. Supr., 5 A.2d 503 (1939); *Yasik v. Wachtel,* Del. Ch., 17 A.2d 309 (1941); and *Penn Mart Realty v. Becker,* Del. Ch., 298 A.2d 349 (1972). These cases stand for the general proposition that one who stands in a fiduciary relationship to the corporation may not act for his personal benefit to the detriment of the corporation and its shareholders. But that principle is not the one involved here. There was no corporate opportunity which Magness acquired for his own profit. There was no potential advantage for the corporation which Magness appropriated to his own use. He did not further his private interests through the use of any corporate position of trust.

[3] In effect, the corporation was insolvent. It could not pay its debts and it could not raise the money on its own, as a separate legal entity, that was needed to forstall the foreclosure action being taken by others. It appears that all Magness did, through his other corporate entity, was purchase this obligation so as to buy some time. When still no remedy was available, he simply went through with the foreclosure sale that had been coming anyway, and at that sale Magness Construction Co. bid more than anyone else—and bid a price which the Superior Court found to be fair and adequate under the circumstances prevailing. In this setting, I cannot understand what fiduciary duty it was that Magness breached. As a 50 per cent shareholder, I fail to see how it became his fiduciary duty to bail the corporation out of all its debt simply because another corporate entity, of which he was the controlling shareholder was financially able to acquire the debt held by third parties against the corporation which the corporation itself was unable to pay. Yet, boiled down, that is what the position of the plaintiff seems to be. No authority is cited in support of such a proposition.

As stated at 7 *Fletcher, Cyclopedia Corporations* (Perm. Ed. 1978) § 3317:

> "Stockholders who are also bondholders and creditors of the mortgager corporation have the same right as any other bondholders or creditors to bid at the sale, if they act in good faith, without any fraud or collusion, and if they have no control over

the property at the time. It is an absolute right in the absence of some trust relation.

* * *

Even a stockholder and director who is also the mortgagee may purchase at the sale."

On the facts and authorities argued by the parties, I find no supporting basis for the plaintiff's contentions. Accordingly, plaintiff's motion for partial summary judgment will be denied, and the motion of the defendants Magness and Magness Construction Co. for summary judgment on the complaint will be granted. An appropriate form of order may be submitted.

NEWS-JOURNAL CO. v. BILLINGSLEY

No. 5774

Court of Chancery of the State of Delaware, New Castle

November 20, 1980

The News-Journal Company and two of its reporters sought the disclosure of certain letters and exhibits contained in the investigatory files of the Delaware Association of Professional Engineers under the Delaware Freedom of Information Act ("Association"). The Court of Chancery, per Vice Chancellor Hartnett, denied plaintiff's application, stating that "disclosure of the investigatory files would have a chilling effect upon those who might bring pertinent information to the attention of the Association." Further, the court held that protecting the Association's ability to investigate and maintain the qualifications of registered engineers takes precedence over a disclosure right.

1. Records ⟸ 14

Investigatory files compiled for law enforcement purposes are not public records and are exempted from disclosure. *Del. Code Ann.* tit. 29, § 10002(d)(3).

2. Records ⟸ 14

Allowing disclosure of investigatory files would have a chilling effect upon those who might bring pertinent information to the attention of the investigating agency, and thus its ability to investigate would be crippled.

3. Records ⟸ 14

The person under investigation has a right of privacy that would be jeopardized by making investigatory files available to private persons.

4. Records ⟸ 14

This right of privacy continues even after the threat of law enforcement proceeding has disappeared.

HARTNETT, *Vice-Chancellor*

This is my decision holding that a certain document in the possession of the defendants does not have to be disclosed to the plaintiffs under the Delaware Freedom of Information Act.

This suit was brought by The News-Journal Company and two of its reporters, as plaintiffs, alleging violations of the Delaware Freedom of Information Act, 29 *Del. C.* Ch. 100. The defendants are the Delaware Association of Professional Engineers ("Association"), established by 24 *Del. C.* Ch. 28, the Council of the Association ("Council") which administers the Association, and the individuals who are members of the Council. The parties have submitted to the Court for *in camera* inspection the document sought and have requested the Court make a determination as to whether the document should be disclosed to the plaintiffs. The document consists of three parts: (1) a three-page letter dated September 10, 1978, from Edwin T. Sherwin, P.E., to the Council which included: (2) a series of exhibits, including copies of publications and contracts, and (3) a letter dated September 11, 1978, in which Mr. Sherwin requests the Council to respect the confidentiality of his communications.

On September 19, 1978, the Council received a formal complaint filed by a Mr. Hijar, alleging a number of violations of the Delaware Professional Engineers' Act (24 *Del. C.* Ch. 28) by certain persons registered as engineers. Pursuant to 24 *Del. C.* §§ 2823 and 2824 the Council is authorized to hear complaints and to take action which can result in the disciplining of registered professional engineers. Additionally, the Council can refer matters to the Attorney General for prosecution pursuant to 24 *Del. C.* § 2825. Mr. Hijar's complaints were investigated by the Council, but dismissed without any action being taken against any registrant. The matter was eventually referred to the Attorney General, who elected not to take action against any parties accused by Mr. Hijar.

Concurrent with the complaints filed by Mr. Hijar, the Council also received the disputed document from Mr. Sherwin, who was a business associate of Mr. Hijar. Both were employees of a company which had sought a contract with the Delaware Solid Waste Authority, but which contract was awarded to Raytheon Service Company. Mr. Hijar's complaints broadly alleged certain improprieties by the Delaware Solid Waste

Authority, Raytheon and certain individuals in connection with the award of that contract to Raytheon.

[1] The defendants contend that the disputed document is confidential information not required to be disclosed to the plaintiffs. I find after reviewing the document *in camera* that the document is not a public record and is exempted from disclosure pursuant to 29 *Del. C.* § 10002(d)(3), and thus I do not need to decide whether other exemptions to the Freedom of Information Act apply. *29 Del. C.* § 10002(d)(3) provides:

> (d) "Public record" is written or recorded information made or received by a public body relating to public business. For purposes of this chapter, the following records shall not be deemed public; . . .
>
> (3) Investigatory files compiled for civil or criminal law-enforcement purposes including pending investigative files, pretrial and presentence investigations and child custody and adoption files where there is no criminal complaint at issue.

The issue presented represents a conflict of two laudable governmental policies. The Freedom of Information Act (*29 Del. C.*, Ch. 10000) is predicated upon the assumption that the workings of a democratic government should be performed in public. The more the public knows about governmental processes, the better able it is to evaluate the performance of public officials on election day. 29 *Del. C.* § 10001. Balanced against this goal of public access to information is the purpose of the Association of Professional Engineers Act (24 *Del. C.*, Ch. 28) which is to safeguard life, health, property and promote the public welfare by regulating the qualifications of profession engineers in Delaware. 24 *Del. C.* § 2802. While there has not been a decision in Delaware resolving this conflict, the Fifth Circuit of the United States Court of Appeals faced this issue in a factually similar case. In *Evans v. Department of Transportation,* 5th Cir., 446 F.2d 821, *cert. den.*, 405 U.S. 918 (1971), an action was brought under the federal Freedom of Information Act to compel disclosure of two letters received by the Federal Aviation Agency referring to a plaintiff's mental fitness and abilities as a commercial airline pilot. The first letter did not identify the plaintiff, but merely asked what course the writer should follow to bring a pilot's overt acts of behavior disorder and mental abnormality to the attention of the proper officials. The second letter, which was sent to the Agency after its assurance to the writer that the letter would be kept confidential, identified the plaintiff by name and set forth in detail the reasons which prompted the writer to believe that the plaintiff "might be too mentally ill to be allowed to fly as a commercial pilot." These letters led to a complete investigation by the Agency into the qualifications of the plaintiff, which resulted in the temporary suspension of the plaintiff's medical certificate

and required him to undergo psychiatric evaluation. Upon completion of the investigation, the plaintiff's medical certificate was restored.

In analyzing these facts, the court pointed out that it was well aware of the critical importance of requiring that commercial airplanes be flown only by pilots who are in good mental and physical health. The protection of the safety of the traveling public is entrusted by law to the Federal Aviation Agency, and as a matter of common sense the efforts of this Agency to investigate and take appropriate action as to the mental and physical health of pilots would be seriously jeopardized if individuals could not confidentially call to the Agency's attention facts which might affect the safety and lives of millions of passengers. The Court held that it was such situations as the one involved in the case which prompted Congress to exempt from the terms of the Act "investigatory files compiled for law enforcement purposes," as set forth in 5 *U.S.C.* § 502(b)(7). Although the federal disclosure act provides a more detailed exemption for investigatory files than the Delaware act, this fundamental language is identical. The Court went on to hold that Congress could not have possibly intended that such letters should be disclosed once the investigation was completed, because if disclosure were made, it would soon become a matter of public knowledge. The result would be that few individuals would come forth to embroil themselves in controversy or possible recrimination by notifying the Agency of something which might justify investigation. The desire of an individual to know the name of the person who had written the letters was, therefore, totally submerged by the public interest. See also, *Frankel v. S.E.C.*, U.S. Ct. of App., 2nd Cir., 460 F.2d 813 (1972); 17 A.L.R. Fed. 522, § 4[a] "Administrative Records—Exempt Files."

[2] If disclosure of the investigatory files of the Delaware Association of Professional Engineers were allowed, there would be a chilling effect upon those who might bring pertinent information to the attention of the Association. Its ability to investigate would be cripplied, and accordingly, its ability to maintain the qualifications of registered engineers would be impaired. Preventing this result must take precedence over a disclosure right.

[3-4] Furthermore, the registered engineer under investigation has a right of privacy that would be jeopardized by making investigatory files available to private persons. This right of privacy would be lost if the file ceases to be confidential as soon as the threat of a law enforcement proceeding disappears. *Cowles Communications, Inc. v. Dept. of Justice,* 325 F. Supp. 726 (1971).

Because the public interest requires that the Council's investigatory powers not be hampered in maintaining the qualifications of registered engineers, and investigated engineers have a continuing right of privacy, the plaintiffs' application for an order compelling disclosure pursuant to 29 *Del. C.* § 10001 et seq. is denied.