Plaintffs have shown that the Schedules 4.09 and 5.05 contained information that would ordinarily be material to the decision the minority must make about whether to tender in response to Grace's offer. That information, however, is more likely to encourage the minority shareholders to accept Grace's offer than to reject it and any delay in consummating the Tender Offer will only delay the receipt of the Tender Offer price by those who tender. The minority shareholders will, therefore, suffer harm if an injunction is granted, but none if it is not. Plaintiffs' motion for a preliminary injunction is therefore denied.

IT IS SO ORDERED.

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## HART HOLDING CO. v DREXEL BURNHAM LAMBERT INC.

No. 11,514

*Court of Chancery of the State of Delaware, New Castle*

May 28, 1992

Plaintiff corporation and its subsidiary brought this action against defendant corporation and a number of limited partnerships, alleging fraud, breach of contract, and breach of fiduciary duty, resulting from alleged conspiracy in connection with plaintiff corporation's leveraged acquisition of all of subsidiary's stock. Plaintiff sought, *inter alia*, to cancel certain shares of subsidiary's common stock registered in the name of several defendants and damages. Action against defendant corporation was stayed due to bankruptcy proceedings. Defendant limited partnerships moved to dismiss for lack of personal jurisdiction while plaintiffs moved for imposition of sanctions as a result of alleged discovery abuses.

The court of chancery, per Chancellor Allen, held that defendant limited partnerships did not have the requisite minimum contacts with the forum to justify subjecting them to personal jurisdiction and declined to authorize a sequestration order to obtain jurisdiction over partnership assets in the forum. Further, the court held that

plaintiffs did not establish that they were entitled to sanctions for alleged discovery abuses.

1. Constitutional Law ⟹305(5)
   Courts ⟹12(2.5)

Under Fourteenth Amendment standards for personal jurisdiction, defendant must have sufficient minimum contacts with forum state and exercise of jurisdiction must be fair and just, taking into account the relationship between the defendant, forum, and litigation, the burden imposed upon the defendant, the forum's adjudicatory interest, the interstate judicial system's interest in the place of adjudication, and the common interest of all affected sovereigns, state and federal, in promoting substantive social policies. U.S. CONST. amend. XIV.

2. Constitutional Law ⟹252
   Partnership ⟹191

A limited partnership accorded the right to sue or be sued in its own name is a "person" under the due process clause of the Fourteenth Amendment for purposes of determining whether it possesses a constitutional privilege against suit in the forum jurisdiction. U.S. CONST. amend. XIV.

3. Constitutional Law ⟹305(5)
   Courts ⟹12(2.5)

The passive receipt of income by defendants from debt and equity securities of Delaware companies does not constitute sufficient contacts with the state to support a finding of minimum contacts.

4. Constitutional Law ⟹305(5)
   Courts ⟹12(2.5)

Personal jurisdiction over a shareholder may be constitutionally permissible where a cause of action relates to specific rights or characteristics inherent in those shares.

5. Constitutional Law ⟹305(5)
   Courts ⟹12(2.5)

Where the subject matter of the litigation involves the legal existence of stock in a Delaware corporation, or its character or

attributes; stock ownership, without more, will ordinarily suffice to satisfy the dictates of common fairness to permit binding adjudication of such a claim in a Delaware court.

6. Constitutional Law ⟹305(5), 495
Courts ⟹12(2.5)

Where cancellation of stock is a remedy for fraud, neither the corporate process nor the validity or attributes of stock is necessarily implicated to justify exercise of personal jurisdiction on the sole basis of the stock ownership.

7. Corporations ⟹342

Under California law, a court will ignore distinctions between a corporation and another entity for the purposes of legal analysis where both entities are merely alter-egos of each other.

8. Corporations ⟹496
Courts ⟹12(2), 15

Under the conspiracy theory of jurisdiction in Delaware, in order to sustain jurisdiction prior to trial, a plaintiff, if challenged, must make a *prima facie* factual showing that (1) a conspiracy to defraud existed, (2) the defendant was a member of that conspiracy, (3) a substantial act or substantial effect in furtherance of the conspiracy occurred within Delaware, (4) the defendant knew or had reason to know of the act in the forum state, and (5) the act in, or the effect on, the forum state was a direct and foreseeable result of the conduct in furtherance of the conspiracy.

Stephen E. Jenkins, Esquire, and Keith R. Sattesahn, Esquire, of Ashby & Geddes, Wilmington, Delaware; Richard J. Wiener, Esquire, and Debra L. Brown, Esquire, of Cadwalader, Wickersham & Taft, New York, New York, of counsel, for plaintiffs.

Martin P. Tully, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware; and Daniel R. Murdock, Esquire, of Donovan, Leisure, Newton & Irvine, New York, New York, of counsel, for defendant Guildford Capital.

Robert K. Payson, Esquire, and James F. Burnett, Esquire, of Potter Anderson & Corroon, Wilmington, Delaware; and Theodore N. Miller, Esquire, of Sidley & Austin, Chicago, Illinois, of counsel, for defendant Raleigh Investment Management.

ALLEN, *Chancellor*

In this action for fraud, for breach of contract and for breach of fiduciary duty, Hart Holding Company Incorporated and its subsidiary, Reeves Industries, Inc., seek, among other relief, to cancel certain shares of Reeves common stock that are currently registered in the name of several defendants and to recover damages. The defendants who hold certain shares of Reeves stock include two California limited partnerships, Guildford Capital, L.P. and Raleigh Investment Management, L.P., and a Delaware limited partnership, Glencoe Investors, L.P. Drexel Burnham Lambert, Incorporated has also been named as a defendant; however, litigation of claims asserted against that firm in this court has been stayed under Section 362 of the U.S. Bankruptcy Code.

Now pending are several motions made by both parties in this case related to jurisdiction of this court over Guildford and Raleigh. Jurisdiction over these two foreign partnerships has purportedly been effectuated through substituted service of process. 10 *Del. C.* § 3104. They each have now filed a motion to be dismissed, asserting that they may not constitutionally be subjected to suit here. They assert that their only relationship with this jurisdiction is that they own shares of a Delaware corporation and that fact is not sufficient to subject them to jurisdiction of the courts of this State.[1]

Plaintiffs have moved for imposition of sanctions as a result of alleged discovery abuses committed by defendants, Guildford, Raleigh and Glencoe after this court entered a discovery order on March 5, 1991. As a sanction for these abuses, plaintiffs request that the court deem admitted facts establishing personal jurisdiction over Guildford and Raleigh and preclude the raising of any jurisdictional defenses. Plaintiffs also request monetary sanctions and attorneys' fees from all of the defendants.

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1. As an alternative to service under our long-arm statute, plaintiffs have moved for a sequestration order, pursuant to 10 *Del. C.* § 366, attaching, in equity, the Reeves shares, thus seeking to compel the personal appearance of the non-resident partnerships, in that manner.

For the reasons set forth below (*infra* pp. 10-29), I conclude that the personal jurisdiction of this court does not extend to these foreign entities in this case. Concluding that the constitutional standard of minimum contacts sufficient to justify subjecting the defendants to personal jurisdiction has not been met here, I decline on these facts to authorize a sequestration order to obtain jurisdiction over assets in this state held by the partnerships. Finally, I conclude that plaintiffs are not entitled to their request for preclusion or monetary sanctions. *See infra* pp. 29-32.

I.

The background of this action and the theory of the plaintiffs' complaint have been sufficiently described in prior opinions in this matter, and I incorporate them by reference here. *See Hart Holding v. Drexel Burnham Lambert*, Del. Ch., 593 A.2d 535, 540-41 (1991); *Hart Holding v. Drexel Burnham Lambert*, Del. Ch., C.A. No. 11,514 (Nov. 7, 1991).

As far as the motion to dismiss is concerned, however, it is helpful to recall the following factual allegations.

Plaintiffs allege that a conspiracy occurred in connection with Hart Holding Company's leveraged acquisition of all of the stock of Reeves Industries. Hart Holding was allegedly induced to select Drexel Burnham as its investment banker in the transaction. Once retained, Drexel, along with certain of its former officers and certain affiliated partnerships, including Guildford and Raleigh, allegedly conspired to pressure Hart, on the eve of the planned closing of the transaction, to agree to the issuance of common stock warrants in order to finance the Reeves acquisition and for additional compensation to Drexel. This entailed, it is alleged, the making of false statements by Drexel and its agents to Hart concerning the necessity to issue warrants to induce sale of bonds.

On May 6, 1986, Drexel allegedly placed 771,587 warrants to purchase common stock of ARA, Inc. (later to become Reeves) with Guildford. *See* Bergman Dep. Tr. 32; Dep. Exh. 32-33.[2] Guildford's

2. Plaintiffs filed on August 27, 1991, the Affidavit of Debra L. Brown which includes the deposition transcripts of Richard Bergman (exh. no. 58), Craig Cogut (exh. no. 59), Joshua Friedman (exh. no. 60) and Edward Victor (exh. no. 61). Plaintiffs have compiled and marked documents that were introduced by them during the depositions. These documents are contained in exhibit numbers 62 and 63 of the Brown Affidavit, and they are referred herein as "Dep. Exh."

general partners were Richard Bergman, an accountant, and Edward Victor, a lawyer; both allegedly had ties to Michael Milken and Drexel officers' investment partnerships. The limited partners of Guildford allegedly include, Michael Milken, several other Drexel officers and employees, the attorney who negotiated the terms of the warrants, and several partnerships owned by Milken and other Drexel employees. *See* Bergman Dep. Tr. 31; Dep. Exhs. 33, 37. Prior to March 23, 1990, Guildford allegedly transferred to Glencoe Investors, a Delaware limited partnership, beneficial ownership of 275,000 of the 771,587 warrants. *See* Cogut Dep. Tr. 134-36; Dep. Exhs. 32, 57, 58 & 59.

Also on or about May 6, 1986, Raleigh purchased from Drexel, 575,168 warrants to purchase common stock of ARA common stock and 300,973 warrants to purchase shares of Schick Incorporated (a predecessor corporation to Hart). These securities had been received by Drexel as part of its compensation. *See* Friedman Dep. Tr. 98-120, 141-50.

Plaintiffs allege that the general partners of Raleigh were officers of Drexel, and the limited partners were Drexel Investors Corporation and two other limited partnerships all of which were allegedly owned, in part, by officers of Drexel. *See* Friedman Dep. Tr. 41-42, 60; Dep. Exhs. 4, 5 (p. 205).

In their request for relief, plaintiffs ask for an accounting and for disgorgement of Drexel's underwriting and placement agent compensation and other renumeration Drexel obtained from plaintiffs, directly and indirectly through defendants Guildford, Glencoe and Raleigh, and for cancellation of shares obtained by defendants upon the exercise of warrants. Plaintiffs also ask for an award of compensatory, consequential and incidental damages. The suit has been stayed insofar as Drexel is concerned, but continues insofar as the alleged joint tort feasors are concerned.

## II.

I turn first to the question of whether Guildford and Raleigh are amenable to suit on this claim in this jurisdiction.

The determination of a motion challenging personal jurisdiction in this case may entail a two-part inquiry: (1) whether Guildford and Raleigh may constitutionally be required to litigate the plaintiffs' claims in this jurisdiction given consideration of their conduct, their relationship with Delaware, and the claims sought to be adjudicated; and (2) whether Delaware statutory law offers a means of exercising personal jurisdiction over Guildford and Raleigh.

For the reasons that follow, I conclude that the governing constitutional standard has not been met.[3] There is, therefore, no occasion to consider whether there are appropriate statutory means to assert jurisdiction over these defendants.

The modern approach to constitutional analysis of personal jurisdiction was first set forth in *International Shoe Co. v. State of Washington*, 326 U.S. 310 (1945). In that watershed opinion, the Supreme Court established fairness as the test of a forum state's ability to exercise personal jurisdiction over a non-resident defendant. The Court announced the so-called minimum contacts standard, in which it posited that the activities of a would-be defendant in, or with respect to, a forum state must be such as to allow the conclusion that exercise of personal jurisdiction over him would be consistent with traditional notions of fair play and substantial justice. In ensuing decisions, the Supreme Court developed the minimum contacts standard and articulated its function:

> The concept of minimum contacts . . . can be seen to perform two related, but distinguishable functions. It protects the defendant against the burdens of litigating in a distant or inconvenient forum. And it acts to ensure the States, through their courts, do not reach out beyond the limits imposed on them by their status as coequal sovereigns in a federal system.

*World-Wide Volkswagen Corp. v. Woodson*, 444 U.S. 286, 291-92 (1980). Notions of foreseeability bear upon fairness. Where a would-be defendant purposefully availed herself of the forum state's benefits and privileges, then she may be said to have reasonably anticipated that she might be required to defend a claim there. In all events, the "constitutional touchstone remains whether the defendant purposefully established 'minimum contacts' in the forum State." *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 474 (1985).

[1] Thus, under present Fourteenth Amendment standards for personal jurisdiction, the court must first ask whether the would-be defendant has sufficient minimum contacts with a forum to make exercise of judicial power over it fair. If none exist, the inquiry is

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3. I am asked to decide this motion based on the pleadings, affidavits and the briefs of the parties. In such a situation it is plaintiffs' burden to establish at least *prima facie* that the exercise of jurisdiction is authorized. *Hart Holding v. Drexel Burnham Lambert*, Del. Ch., 593 A.2d 535, 539 (1991).

at an end. If, however, minimum contacts do exist, the inquiry continues in order to assess whether it would be fair and just to require a would-be defendant to litigate the dispute in that forum. The court must examine, among others, the relationship among the defendant, the forum, and the litigation (*see Shaffer v. Heitner*, 433 U.S. 186 (1977)), the burden imposed on the defendant, the forum's adjudicatory interest, the interstate judicial system's interest in the place of adjudication, and finally, the common interest of all affected sovereigns, state and federal, in promoting substantive social policies (*see Burger King*, 471 U.S. at 477; *Keeton v. Hustler Magazine, Inc.*, 465 U.S. 770, 775 (1984)).

* * *

The privilege against suit in a jurisdiction with which one has established no contact, is an attribute of personhood under the Fourteenth Amendment (that is to say, it is the Fourteenth Amendment that is the source of the "right"). Before turning to plaintiffs' arguments, it is necessary, in my mind, to dilate briefly on the question whether Guildford and Raleigh do possess such a privilege under the Constitution. Neither party has raised this issue in its brief or at oral argument and both treat the limited partnerships as entities possessing this privilege.

It has been recognized for slightly more than a century that corporations are persons under the Fourteenth Amendment that, generally, enjoy constitutional protection. *See, e.g.*, *First Nat'l Bank of Boston v. Bellotti*, 435 U.S. 765 (1978), *reh'g denied*, 438 U.S. 907 (1978) (First Amendment protections); *Minneapolis R.R. Co. v. Beckwith*, 129 U.S. 26 (1889) (due process); *Santa Clara Co. v. Southern Pac. R.R.*, 118 U.S. 394 (1886) (equal protection). Research discloses no case addressing the question whether a limited partnership that has, under the law of its creation, the power to sue and be sued in its own name, similarly will be treated as a person for the purposes of the Fourteenth Amendment. Several U.S. Supreme Court cases have established that a limited partnership is *not* a person for diversity jurisdiction purposes (28 U.S.C. § 1332), but I do not regard that question as truly dispositive of the constitutional question. *See Carden v. Arkoma Assocs.*, 110 S. Ct. 1016 (1990);[4] *Great S. Fire Proof Hotel Co. v. Jones*, 177 U.S. 449 (1900).

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4. In its most recent pronouncement, *Carden v. Arkoma Assocs.*, 110 S. Ct. 1016 (1990), the Supreme Court held that, unlike a corporation, a limited partnership is not a "citizen" for the purposes of determining diversity jurisdiction. Under the

Whether a corporation is a "person" under the Fourteenth Amendment was first determined by the Supreme Court in *Santa Clara*, 118 U.S. at 396. Although that case only briefly mentioned that equal protection rights of the Fourteenth Amendment applied to corporations, it established that, in order to protect constitutionally-granted rights of stockholders, corporate entities are "persons" within the meaning of the Fourteenth Amendment. *See* Horwitz, Santa Clara *Revisited: The Development of Corporate Theory*, 88 W. Va. L. Rev. 173 (1986). *See First Nat'l Bank of Boston v. Bellotti*, 435 U.S. 765 (1978); *compare Hale v. Henkel*, 201 U.S. 43 (1906) (corporations cannot claim Fifth Amendment privilege against self-incrimination).

Under the law of its creation, a California limited partnership, like a limited partnership in every state that has enacted the Uniform Limited Partnership Act,[5] may be subjected to suit in its own name.[6] This may conceivably be done in any jurisdiction of this country. In the event that a limited partnership is sued in a distant jurisdiction with which it has no minimum contacts,[7] can it be the case that the Fourteenth Amendment affords to it no constitutional right to invoke the *International Shoe* principle? In my opinion, the answer is plainly no. In so concluding, I am influenced by several considerations. First, the Supreme Court has noted that one of the supports of the *International Shoe* approach is the territorial limitation of state court jurisdiction. That limitation is just as real when a legal entity created

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Court's formulation, a federal court, in determining whether or not there is diversity of citizenship among parties, must look to the citizenship of the limited partnership's various partners, both limited and general.

The issue whether or not a limited partnership should be granted status as a citizen of a state for the purposes of determining diversity of citizenship is wholly a federal matter governed by federal statute, the question whether a partnership is to be treated juridical "person" under the Fourteenth Amendment for the purposes of determining whether *it* has a venue-privilege is an issue that is distinct from determinations of the meaning of the word "citizen" under Article III of the Constitution, and, for diversity purposes, under 28 U.S.C. § 1332.

5. As of this writing, 48 jurisdictions (including California) have enacted the Revised Uniform Limited Partnership Act (1976). *See, e.g.*, R.U.L.P.A. § 104 (Specified office and agent), § 901 (Registration of foreign limited partnerships) (West Supp. 1992).

6. *See* Cal. Code Civ. Pro. § 388(a) (Deering 1991) ("Any partnership or other unincorporated association . . . may sue and be sued in the name which it has assumed or by which it is known."); Cal. Bus. & Prof. Code § 15,692 (Deering 1992); *H & M Assocs. v. City of El Centro*, 109 Cal. App. 3d 399, 167 Cal. Rptr. 392 (1990).

7. For purposes of analysis, assume some statutory basis for service of process was nevertheless present.

by the laws of a sister state is a defendant as when an individual citizen of a sister state is involved. Second, unlike the construction of the diversity jurisdiction statute, there is, in this context, no apparent reason to distinguish between a corporate entity and another type of legal entity that is given that character by the law of its creation. Thirdly, and relatedly, the partners' financial interests in the partnership are implicated in a suit in just the way the shareholders' interests are implicated in a suit against a corporation. The rationale for treating corporate entities as Fourteenth Amendment persons extends easily to other entities that are created as such by state law.

[2] Thus, I conclude that a limited partnership that is accorded the right to sue or be sued in its own name, is a "person" under the due process clause of the Fourteenth Amendment for purposes of determining whether it possesses a constitutional privilege against suit in the forum jurisdiction. *See Donatelli v. National Hockey League*, 893 F.2d 459 (1st Cir. 1990) (a non-incorporated entity possessed such a privilege and cannot be subject to jurisdiction simply because a member carries on in-forum activities that are not under the influence of the association).

III.

I turn now to address plaintiffs' specific constitutional arguments. They argue that, under the minimum contacts test, (1) both partnerships have maintained sufficient minimum contacts with Delaware to warrant exercise of jurisdiction; (2) the subject matter of the lawsuit is directly related to Guildford's and Raleigh's ownership of stock in Reeves, a Delaware corporation, and therefore jurisdiction is appropriate; and (3) even without minimum contacts of their own, the partnerships are either part of an enterprise or part of a conspiracy which has had sufficient contacts with Delaware to render the defendants amenable to suit here.

I address each of these arguments, in turn, below.[8]

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8. As a preliminary argument, plaintiffs claim that Guildford and Raleigh waived any objections to personal jurisdiction by affirmatively participating in settlement proceedings and in petitioning this court for affirmative relief. Specifically, plaintiffs contend that defendants agreed to settle this litigation on July 25, 1990. Weiner Aff. ¶ 6; Bevilacqua Aff. ¶ 6. However, no settlement proceedings subsequently took place in this court, and, on September 5, 1990, Guildford filed a motion, later joined by Raleigh, to dismiss the action for lack of personal jurisdiction.

A. *Are Guildford's and Raleigh's contacts with Delaware sufficient to warrant a finding of personal jurisdiction?*

Discovery has exposed no continuing or sporadic connection between either Guildford and Raleigh and this jurisdiction, other than the facts asserted in connection with the conspiracy theory plaintiff addressed below, and their investments in the securities of Delaware corporations.

Plaintiffs urge that the partnerships' investments in the securities of Delaware companies and the receipt of income from these companies creates a general affiliation with the state. They urge that, since their inception, the partnerships have engaged in the single business activity of making investments in Delaware-based entities. The partnerships' income was derived principally from interest or dividends paid by Delaware corporations. This amounts to continuous and substantial contacts with the state, they assert.

With respect to Guildford, plaintiffs say, the record indicates that it invested in only two companies' securities (both incorporated in Delaware): in Schick/ARA debt and warrants, and Coast Holdings Corporation debt and common stock. *See* Bergman Dep. Tr. 32, 90; Dep. Exhs. 32, 33, 45. With respect to Raleigh, plaintiffs say it invested, directly or through other Drexel partnerships, in a larger number of companies, and almost all of them were incorporated in Delaware. *See* Friedman Dep. Tr. 164-67; Dep. Exhs. 28, 29.

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Then, on September 25, 1990, plaintiffs filed a motion for specific performance of the settlement agreement. On October 31, 1990, Guildford moved to stay plaintiffs' specific performance motion until after defendants' motion to dismiss had been decided, and plaintiffs consensually agreed to defer decision on their motion for specific performance. Jurisdictional discovery was ordered by this court and defendants then applied on several occasions for a protective order for confidential documents. Plaintiffs emphasize that in all but the last of these applications defendants did not expressly preserve any jurisdictional defenses.

I agree with the plaintiffs that it is well-established that personal jurisdiction is a waivable right, but I cannot agree that the defendants waived jurisdiction here. Settlement of a lawsuit does not constitute a waiver of jurisdictional objections unless the parties affirmatively invoke a court's power. *See, e.g., Meetings & Expositions, Inc. v. Tandy Corp.*, 490 F.2d 714, 717 (2d Cir. 1974); *Securities Training Corp. v. Securities Seminar, Inc.*, 633 F. Supp. 938, 939-40 (S.D.N.Y. 1986); *Orange Theatre Corp. v. Rayherstz Amusement Corp.*, 139 F.2d 871, 873-74 (3d Cir.), *cert. denied*, 322 U.S. 740 (1944). In my opinion, the posture of the defendants has been to challenge personal jurisdiction since September 5, 1990, before any application (September 25, 1990) by plaintiffs to enforce an alleged settlement agreement. In addition, the final protective order entered by this court contains express reservation of the parties' position on jurisdictional issues. *See Nacci v. Volkswagen of Am., Inc.*, Del. Supr., 297 A.2d 638 (1972).

[3] In my opinion, the passive receipt of income by defendants from debt and equity securities of Delaware companies does not constitute sufficient contacts with the state to support a finding of minimum contacts. *International Shoe, supra,* and later cases require a practical analysis of contacts and foreseeable consequences. The isolated act of investing in the shares of a Delaware corporation creates a foreseeable relationship with this state in only one respect: the law of Delaware will determine the nature of the rights thereby acquired. While that relationship is sufficient alone to support *in personam* jurisdiction in a narrow class of cases (*see Hynson v. Drummond Coal Co.*, Del. Ch., 601 A.2d 570 (1991), discussed *infra*), it surely cannot support *in personam* jurisdiction for a general conspiracy and fraud claim. *See, e.g., Burger King,* 471 U.S. at 477.

* * *

Plaintiffs also argue that both Guildford and Raleigh transacted business in Delaware specifically related to the present action.

Plaintiffs point to several acts conducted by the partnerships as proof of their claim. Shortly after acquiring subordinated debt securities in the Hart financing, Guildford allegedly resold the debt, but not the warrants, to Drexel for a profit. *See* Dep. Exhs. 32, 55, 56. Next, Guildford allegedly transferred some of the warrants to Glencoe Investors, a Delaware partnership. *See* Dep. Exhs. 32, 57, 58, 59.[9] Plaintiffs allege that further discovery has uncovered the fact that Raleigh engaged in at least two transactions with MacAndrews & Forbes, a Delaware corporation, which purchased some of the debt and warrants in the financing. *See* Brown Aff. Exhs. 10, 11, 40; Dep. Exhs. 4, 27. Finally, plaintiffs allege that both Guildford's and Raleigh's exercise of the warrants for Reeves stock constituted an act within Delaware.

This argument is inconsistent, in root and branch, with the animating idea behind *International Shoe, supra,* and its progeny, especially *Shaffer v. Heitner, supra.* The fact of the state of incorporation of the corporation's issuing the securities is—with respect to the matters here in issue (but not with respect to all issues, *see* below)—in this case a metaphysical fact of no operational or legal significance. Generally, *International Shoe, supra,* mandates practical, not metaphysical, evaluations of connections. Thus, I cannot accept plaintiffs'

9. None of the witnesses deposed by plaintiffs could recall the circumstances surrounding Guildford's sale of debt to Drexel and sale of warrants to Glencoe. *See, e.g.,* Cogut Dep. Tr. 129-33.

argument that these transactions and affiliations constituted any contact among the partnerships and Delaware for the purposes of personal jurisdiction analysis.

No evidence is offered that any negotiations surrounding the transfer of debt securities and warrants took place in Delaware. *See Greenly v. Davis*, Del. Supr., 486 A.2d 669 (1984) (affirming a holding that negotiation of an alleged contract by residents of Pennsylvania did not amount to a transaction of business in Delaware even though a part of the negotiations included the proposed sale of stock of a Delaware corporation).

B. *Is the subject matter of the lawsuit sufficiently related to property held by Guildford and Raleigh to warrant a finding of personal jurisdiction?*

Plaintiffs also offer a theory of jurisdiction based upon defendants' ownership of the Reeves stock. They assert that the Reeves stock that Guildford and Raleigh own is the focus of this litigation. The underlying causes of action relate to that stock, they say, and the relief sought is, in part, cancellation of the stock. Thus, they argue that defendants do not merely own property with a legal situs in Delaware, the property *is the subject of the litigation*. This close relationship between the property in question and the litigation is enough, they argue, to make it fair to subject defendants to personal jurisdiction for the purpose of litigating the claims. *See Shaffer*, 433 U.S. at 207-08.

[4] Without exploring the various legal distinctions made between *in rem* and *in personam* jurisdiction, I find the plaintiffs' argument to be misplaced here. This court has previously held that personal jurisdiction over a holder of shares (with their legal situs in Delaware) may be constitutionally permissible where a cause of action relates to specific rights or characteristics inherent in those shares. Such rights or characteristics spring from the shares themselves (e.g., voting rights, authenticity of certificates, etc.). *See Hynson v. Drummond Coal Co.*, Del. Ch., 601 A.2d 570 (1991).

Plaintiffs allege in their complaint that the Reeves warrants were invalidly issued as a result of Drexel's fraudulent behavior and breach of fiduciary duties and contract obligations owed to Hart. *See* Compl. ¶¶ 46-59. They request as a remedy that the Reeves shares be declared by this court to be invalid. Assuming the facts alleged to be true, the entitlement of Reeves to cancel the shares will rest upon findings *related to the fraud and fiduciary duties claims* and will not rest upon an examination of *the rights inherent in the shares* themselves.

Indeed, the fiduciary and contractual obligations alleged by plaintiffs are unrelated to the remedy sought—the cancellation of Reeves shares.

[5-6] That is, where the subject matter of the litigation involves the legal existence of stock in a Delaware corporation, or its character or attributes (e.g., its validity or its right to vote or for a liquidation preference, etc.), I am convinced that ownership of the stock, without more, will ordinarily be sufficient to satisfy the dictates of common fairness to permit binding adjudication in this court of such claim, without regard to where the holder may reside. I expressed the reasons for this view in *Hynson, supra*. Superficially, plaintiffs' complaint may seem to fall under that principle since they seek the cancellation of stock. But while the complaint seeks cancellation of stock, it does so as an equitable remedy for fraud, personal to the plaintiff, not by reason of some alleged defect in the corporate process by which the warrants were authorized or the stock issued. Where cancellation of stock is a remedy for fraud, it does not necessarily implicate the corporate process or the validity or attributes of stock. In such a situation, I cannot conclude, as in *Hynson*, that ownership of shares itself is enough to satisfy the constitutional test of minimum standards.

Let me give an example. Suppose A, an individual resident of Illinois is defrauded in Los Angeles by B, an individual resident of California of 10,000 shares of common stock of a Delaware corporation. The certificates are delivered with stock power in Los Angeles and B thereafter has them transferred on the company books (New York) into his nominee's name. A sues B for fraud and seeks a mandatory injunction requiring the return of the stock and damages. It is plain, I suppose, that Delaware would not be among the places in which A may plausibly require B to litigate that claim. The fact that the property, of which plaintiff was allegedly wrongfully deprived, was created under the law of this State (and is governed by that law in most respects) is plainly and simply irrelevant to a judgment of fairness of the location of that litigation, on the hypothetical facts.

Now change the hypothetical in this respect: Assume A is the issuing corporation. In this revised hypothetical, it does not seek a mandatory injunction requiring a reconveyance by defendant. Since it controls its own books and records, it seeks only a judicial declaration that it may cancel the stock (and collect damage as here). Can that distinction make any difference in a constitutional analysis under the *International Shoe* line of cases? In my opinion it cannot. The issuer in this instance sues as a defrauded person. The request

for cancellation is, in this case, simply a remedy for fraud. I cannot understand that the request for such a remedy can itself make it fundamentally fair to litigate in this jurisdiction, a claim that if brought by a non-issuer could plainly not be required to be litigated here.

In so saying, I reaffirm my opinion that in a narrow class of cases, where class-wide rights or duties of stock are to be adjudicated, the mere holding of stock in a Delaware corporation may, consistent with our traditional notions of fairness, be sufficient to bind all holders to the judgment reached, regardless of their other contacts with the State. For the reasons stated above, that principle is not applicable here.

In summary, I find the cause of action here to be related to the conduct of Drexel and perhaps its co-conspirators and wholly unrelated to a dispute over rights inherent in the Reeves shares themselves. In these circumstances, the requests for remedy of cancellation does not itself add anything to the constitutional analysis, in my opinion.

C. *Are the enterprise and conspiracy theories of jurisdiction applicable to the present motion, and if so, have the standards been met for each theory?*

Plaintiffs also offer enterprise and conspiracy theories as bases for concluding that it is fair to subject the partnerships to personal jurisdiction in this state.

Under the enterprise theory, plaintiffs' allege that Guildford and Raleigh are part of a single enterprise controlled by Drexel, a Delaware corporation. They claim that Drexel Burnham Lambert, Incorporated formed and exercised control over the partnerships for investment and compensation purposes. The partnerships allegedly were shell entities and had no employees and relied upon services of senior Drexel employees. These employees, members of Drexel's High Yield Bond and Corporate Finance departments, allegedly selected the persons who participated in the partnerships and determined what investments they made. Guildford and Raleigh were allegedly owned by Drexel, professionals and employees who worked for Drexel, former Drexel professionals and employees and other Drexel partnerships.

In support of their allegations against Guildford, plaintiffs point to language in Guildford's limited partnership agreement which restricts ownership of Guildford's assets to "employees of the High Yield and Convertible Bond Department of Drexel Burnham Lambert

Incorporated, or [persons who] otherwise maintain a business relationship (i.e., consultant-client) with Partners owning not less than 75% of the Partnership Percentages." Dep. Exh. 35, p. 15. When a partner of Guildford is no longer employed or associated with the High Yield Bond Department or Drexel, an event of "Termination of Employment" results. *See id.* This subjects a partner to costly adjustments in his capital account (*id.* at 15, 17) or, if the terminated partner engages in activities in competition with Drexel, expulsion from Guildford. (*Id.* at 22). The date of Termination of Employment is:

> the earlier of (i) the date said Partner leaves the employment of the High Yield and Convertible Bond Department of Drexel Burnham Lambert Incorporated, or (ii) said Partner is no longer associated with the Partners owning not less than 75% of the Partnership Percentages, or (iii) the effective date of "expulsion" of said Partner from Otter Creek Associates pursuant to the Partnership Agreement thereof.

*Id.* at 16. Otter Creek Associates is a partnership owned by members of the Drexel High Yield Bond Department. *See* Dep. Exh. 5, p. 204; *see also* Cogut Tr. 92-95; Bergman Tr. 43-45. The Guildford partnership agreement also places severe restrictions on the interest that a partner's spouse may hold in Guildford.

Plaintiffs also argue that Guildford's general partners, Richard Bergman and Edward Victor, both worked for Drexel, its partnerships and Drexel employees. *See* Bergman Dep. Tr. 49-50; Cogut Dep. Tr. 16. Finally, plaintiffs point to the fact that all of Guildford's limited partners were (1) former Drexel employees, including Michael Milken, Lowell Milken and Peter Ackerman, (2) former consultants/lawyers for Drexel, including Craig Cogut, and (3) Drexel limited partnerships, including Financial Partners and General Financial. *See* Bergman Dep. Tr. 31; Cogut Dep. Tr. 104; Dep. Exhs. 33, 37.

In support of their allegations against Raleigh, plaintiffs point to language of Raleigh's limited partnership agreement which contains strict restrictions on permitted transfers of partnership interests, restrictions on the interest of a partner's spouse prohibiting the spouse from being admitted as a partner, and limits on the spouse's right to receive distributions. *See* Brown Aff. Exh. 57, pp. 19-20, 22-23. In addition, plaintiffs point to the fact that the partnership's general partners are three former employees of Drexel's High Yield Bond Department: Joshua Friedman, Robert Davidow and Marc Rappaport. *See* Dep. Exh. 4. The limited partners included Ocelot As-

sociates (a limited partnership owned by former Drexel High Yield Bond Department employees), Valcour Associates II (a partnership owned by former Drexel Corporate Finance Department employees and capitalized through the Department's bonus pool) and Drexel Investors (a corporation owned by Drexel). *See* Cogut Dep. Tr. 191-94; Friedman Dep. Tr. 55-56, 77, 84; Dep. Exhs. 4, 5, 8, 9, 90.

Plaintiffs also allege that both partnerships were created as compensation devices for Drexel employees and, in support of this theory, they offer deposition testimony of Drexel's attorney Craig Cogut, who stated, "I have a general understanding that [the partnerships] were formed effectively as a compensation device to make people focus on work, not on making their own investments." Cogut Dep. Tr. 50. Furthermore, plaintiffs argue that both partnerships were specifically formed to invest in the securities of companies for which Drexel was providing investment banking or advisory services, and that these services were being offered at the time in which the partnerships were making investment. *See* Cogut Dep. Tr. 75-76, 81-82, 165, 196, 201; Friedman Dep. Tr. 69, 101-06, 112-14.

Finally, by pointing to the deposition testimony of Messrs. Cogut and Bergman, plaintiffs argue that (1) the overall administration of Guildford and Raleigh was handled by Lowell Milken, a former Drexel Senior Vice President; (2) Drexel exercised control over the partnerships' investments by way of control over accounts that each of the partnerships held at Drexel; (3) a high degree of coordination existed between Drexel, Guildford and Raleigh with respect to partnership investments (i.e., the partnerships invested simultaneously in several companies); (4) the partnerships were essentially shell entities (i.e., the partnerships used the same address, "loaned" each other money to fund investments, and each had general partners who were ignorant of the specifics of the partnerships' operations); and (5) Drexel indemnified the partnerships for any liability they might incur in connection with securities transactions.

Plaintiffs offer two specific instances in which deposition testimony allegedly reveals that there were direct contacts between Drexel and each of the two partnerships.[10] In the first instance, plaintiffs

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10. Plaintiffs also offer supplemental information in support of their claim that Drexel authorized, approved of, and benefitted from the use of limited partnerships as compensation and investment vehicles for certain of Drexel's employees. Specifically, the plaintiffs submitted to the court a copy of an *Answer, Counterclaim and Third Party Complaint*, dated November 19, 1991, filed by Michael Milken and

offer the testimony of Craig Cogut, taken during a hearing before Judge Kimba Wood, in the United States District Court and confirmed in his deposition, as follows:

> Q. Was it your understanding that there was a process in New York for reviewing and clearing or objecting to any transactions by the employee partnerships?
> A. Yes.

Exh. 74, p. 947; Cogut Dep. Tr. 58-60. Plaintiffs offer, in the second instance, the deposition testimony of Richard Bergman, general partner of Guildford, in connection with the partnership's sale of ARA and Coast Holdings to Glencoe:

> Q. Can you describe your involvement to me in each of the 2 sales?
> A. My recollection is very hazy, but I recall discussing the sale of ARA with a member of the investment department of Drexel Burnham.
> And I also recall discussing the sale of the Coast Holdings securities with a member of the investment department of Drexel Burnham.
>
> * * *
>
> My recollection is that the discussions with the individuals in the investment department at Drexel involved the transfer of the securities from Guildford to Glencoe, and the transfer of cash from Glencoe to Guildford.
>
> And I believe they were involved in effecting that transfer by transferring the funds from Glencoe to Guildford.
>
> * * *
>
> So in response—and, again, I'm not an attorney—but in response to Mr. Leifer, I believe they were involved—that question relates to the investment of cash by Glencoe in securities.

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Lowell Milken in an action pending in federal court for the Southern District of New York (91 Civ. 6108 (MP)). In this document, Mr. Milken states that Drexel authorized and encouraged the creation of various partnerships as investment vehicles for the firm's employees. The partnerships were allegedly used as a means of attracting, motivating, and retaining outstanding employees. This information is offered to support further the plaintiffs' contention that the partnerships merely acted as agents or instrumentalities of Drexel and should not be treated as separate and distinct entities for purposes of legal analysis.

I decline to place evidentiary weight upon a pleading filed by a third-party in an on-going suit.

Bergman Dep. Tr. 160-62.

Thus, in sum, plaintiffs argue that Guildford and Raleigh were controlled by Drexel, and were, in essence, separate entities from Drexel in name alone, and that, as such, no valid legal distinctions can be made between Drexel and the partnerships (for purposes of acquiring *in personam* jurisdiction). This corporate enterprise, they argue, has sufficient contacts with Delaware. In the alternative, even if there is insufficient evidence to find that the partnerships were effectively part of Drexel's corporate enterprise, plaintiffs argue that there is sufficient evidence to show that Drexel controlled them as instrumentalities and that the partnerships were merely agents of Drexel.

* * *

The so-called enterprise theory of personal jurisdiction appears to be the creation of the judges of the United States District Court for the District of Kansas. *See Hoffman v. United Telecommunications, Inc.*, 575 F. Supp. 1463 (D. Kan. 1983); *Energy Reserves Group, Inc. v. Superior Oil Co.*, 460 F. Supp. 483 (D. Kan. 1978). It has not met with wide or easy acceptance elsewhere. It certainly does not represent the law of Delaware.[11] But the law of Delaware is not the applicable law in this instance where the question is whether a foreign entity has a constitutional privilege against being subjected to suit in this jurisdiction. That question is one, first of all of constitutional law, which has been addressed above (*see supra* pp. 5-10) and, derivatively, of the law of the creation of the entity. (That is the question, when does that entity cease to be accorded the right to its distinct legal status, is a question to be decided by the law that creates that distinct status in the first instance.)

[7] Under California law, a court will ignore distinctions between a corporation and another entity for the purposes of legal analysis where both entities are merely the alter-egos of each other. That is, a court will make such a determination when it is shown:

> '(1) that there be such unity of interest and ownership that the separate personalities of the corporation and individual no longer exist and (2) that, if the acts are treated as those

11. Our law tends to accord dignity to legal entities except in cases in which the traditional law of piercing the corporate veil is met. *See, e.g., Buechner v. Farbenfabriken Bayer Aktiengesellschaft*, Del. Supr., 154 A.2d 684 (1959); *Sears, Roebuck & Co. v. Sears plc*, 744 F. Supp. 1297, 1304 (D. Del. 1990); *Mobile Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260, 265-72 (D. Del. 1989).

> of the corporation alone, an inequitable result will follow.' (*Automotriz etc. De California v. Resnick* (1957) 47 Cal.2d 792, 796, 306 P.2d 1.)

*Shapoff v. Scull*, 222 Cal. App. 3d 1457, 1469-70, 272 Cal. Rptr. 480, 486 (1990).

Here, I do not find sufficient evidence in the record to demonstrate, *prima facie*, that Drexel itself, and not certain employees individually, controlled and dominated the partnerships. The partnership may indeed have been dominated and controlled by certain employees of Drexel; however, this does not lead to the conclusion that Drexel, the corporate entity, controlled and directed the operations of the partnerships. The Drexel employees that allegedly controlled and dominated the partnerships are not now named as defendants, and in all events, their actions have not been demonstrated to be one and the same as those of Drexel.

While the deposition testimony of Messrs. Cogut and Berman tend to show that there was a relationship between the partnerships and Drexel, that testimony does not show, *prima facie*, that this relationship involved exclusive domination and control by Drexel of the partnerships to the point that they no longer had legal or independent significance of their own. Thus, I cannot conclude that plaintiffs have shown that these partnerships were so dominated by Drexel as to become alter-egos of the corporation, or even its agents, for the purposes of finding personal jurisdiction.

In summary, the partnerships have independent legal significance as persons for the purposes of jurisdiction analysis. It has not been shown that they are merely the alter-egos or instrumentalities of Drexel, and any jurisdiction that this court might have over the partnerships must result from a finding of minimum contacts that the partnerships have with Delaware, apart from any contacts that Drexel may have with this state.

* * *

As an alternative to their enterprise theory, plaintiffs also offer a conspiracy theory of jurisdiction. The complaint charges that the Reeves shares in question were issued on the exercise of warrants that were obtained by Guildford and Raleigh as the result of a conspiracy involving misrepresentations, deceit and manipulation of Hart by Drexel. Drexel allegedly used both deception and its position of dominance and control over the high yield financing marketplace to pressure Hart to agree to issue additional securities in its purchase of Reeves. Thus, this conspiracy allegedly had as its object the extracting of warrants from Hart under false pretenses. Plaintiffs

assert that these California entities as "beneficiaries" of this deceit, must be regarded as co-conspirators with Drexel and subject to *in personam* jurisdiction in this State.

[8] Under the conspiracy theory of jurisdiction in Delaware, in order to sustain jurisdiction prior to trial, a plaintiff, if challenged, must make a *prima facie* factual showing that (1) a conspiracy to defraud existed, (2) the defendant was a member of that conspiracy, (3) a substantial act or substantial effect in furtherance of the conspiracy occurred within Delaware, (4) the defendant knew or had reason to know of the act in the forum state, and (5) the act in, or the effect on, the forum state was a direct and foreseeable result of the conduct in furtherance of the conspiracy. *Instituto Bancario Italiano v. Hunter Eng'g Co.*, 449 A.2d 220, 225 (1982).

Plaintiffs contend that they have made a sufficient factual showing that: (1) a conspiracy to injure the plaintiffs through the authorization and issuance of warrants existed; (2) Guildford and Raleigh were members of the conspiracy; (3) Drexel caused Hart and Reeves to file documents with the Delaware Secretary of State effecting the merger and increasing the number of authorized shares to be issued upon exercise of the warrants;[12] (4) Guildford and Raleigh had knowledge of these acts in Delaware through their affiliation with Drexel; and (5) the authorization and issuance of new, previously unissued, shares in Reeves through the use of Delaware law is a direct and foreseeable result of the conspiracy. *See* Compl. ¶¶ 60-69.[13]

In the Memorandum Opinion of February 13, 1991 (593 A.2d at 535), I stated that, in this action, the conspiracy theory was a non-frivolous theory upon which personal jurisdiction might be found in this instance, and I therefore permitted discovery to proceed with respect to it. Upon consideration of the evidence presented by plaintiffs, I cannot conclude that plaintiffs have presented *prima facie*

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12. The documents were actually filed *by plaintiffs* with the Secretary of State of Delaware, and they include a certificate incorporating SAC, a wholly owned subsidiary of ARA; a certificate of merger, merging SAC into Newreeveco, Inc.; and a certificate amending the corporate charter of ARA.

13. Plaintiffs base their conspiracy allegations on the factual allegations made in their complaint. They claim that they did not seek discovery on their conspiracy allegations because the partnerships represented to them, and to the court, that they would accept as true the complaint's factual allegations. *See* Brown Aff. Exhs. 32-34. I accept plaintiffs' claim that the defendants have agreed to take the factual allegations made in the complaint as true. Therefore, in considering their conspiracy argument, I rely on the facts as stated in the complaint.

evidence to support the invocation of personal jurisdiction. Here, even accepting, *arguendo*, that evidence of a conspiracy involving the partnerships exists, I find insufficient evidence that a co-conspirator did an act or had an effect in this jurisdiction.

The Delaware Supreme Court's *Instituto Bancario*, *supra*, decision is instructive here. There, it was alleged that a Delaware corporation fraudulently issued its shares to its foreign parent. The parent sold the shares to another foreign corporation. The issuing corporation, its parent, and the foreign buyer were all named as defendants. Plaintiffs brought an action to cancel the shares held by the foreign purchaser. The Court held that the Delaware corporation's filing of a certificate of amendment to its charter, to enable it to issue new shares, was a "substantial act" within the state for the purposes of finding a conspiracy among the defendants.

Here, neither Drexel nor any other defendant filed a document in Delaware as part of the action upon which the claim is based. In this instance, plaintiff itself filed whatever papers were necessary to effect the corporate transactions involved. It is no doubt the case that the Drexel officers (and presumably the partnerships) expected that plaintiff would do so, but that is rather different than their doing an act in this jurisdiction. The Supreme Court of the United States has emphasized that, for *International Shoe* purposes, it is crucial that a foreign defendant *do some act creating a contact* with the forum state where plaintiff seeks to require a defendant to litigate a claim. Where, as here, the only connection with the forum is a single act, it seems minimal to require that at least that act be the act of the alleged conspirators and not of plaintiff itself.

I, thus, conclude that the record does not establish, on a *prima facie* basis, that these California limited partnerships may be subjected to suit here by crediting to them all acts of their alleged co-conspirators in furtherance of the conspiracy. Here, no defendant has been shown to have done any substantial act in, or causing an effect in, this jurisdiction.

## IV.

I now turn briefly to the plaintiffs' motion for preclusion and monetary sanctions. In summary, plaintiffs argue that Guildford and Raleigh did not produce documents that were responsive to their discovery requests following a discovery order entered by this court on March 5, 1991. They claim that some of the documents were ultimately separately obtained from the S.E.C. They also contend

that defendants obstructed the taking of depositions by the use of baseless colloquy and objections. It is further alleged that the defendants abused the attorney-client privilege by offering it as a potential roadblock to the taking of depositions of certain witnesses when, in fact, it was not applicable. Finally, plaintiffs contend that Drexel and Glencoe affirmatively obstructed discovery by delaying deposition testimony and refusing to produce documents.

As a partial remedy, plaintiffs ask, pursuant to Chancery Rules 37(b)(2)(A) and 37(b)(2)(B),[14] that the court take the facts concerning personal jurisdiction as established, deny Guildford and Raleigh the right to raise jurisdictional defenses and prohibit them from introducing matter into evidence contesting jurisdiction. Plaintiffs also seek monetary sanctions, including an award of attorneys' fees, costs and expenses incurred in opposing the jurisdictional motions.

Plaintiffs have provided extensive detail in their briefs pertaining to the alleged discovery abuses, including references to the specific difficulties which they faced in the taking of depositions. While plaintiffs may have found that the defendants' attorneys were less than cooperative, I recognize that there is sometimes a fine distinction between zealous advocacy and obstruction of complex litigation. There is also room for reasonable minds to disagree as to the scope and extent of a discovery order and a party's request for production of documents. This does not mean that defendants' counsel is free to pick and choose what information and witnesses should be made available to plaintiffs, all the while hiding behind their own interpretation of the court's discovery order. I find, however, that there is not sufficient evidence here to approve plaintiffs' request for monetary sanctions at this time in the proceedings.

On the issue of preclusion, plaintiffs rely upon *Insurance Corp. of Ireland v. Compagnie Des Bauxites*, 456 U.S. 694 (1982) and Rule

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14. These two rules state, in pertinent part:

(2) *Sanctions by Court.* If a party or an officer, director, or managing agent of a party . . . fails to obey an order to provide or permit discovery . . . the Court may make such orders in regard to the failure as are just, and among others the following:

> (A) An order that the matters regarding which the order was made or any other designated facts shall be taken to be established for the purposes of the action in accordance with the claim of the party obtaining the order;
>
> (B) An order refusing to allow the disobedient party to support or oppose designated claims or defenses, or prohibiting him from introducing designated matters into evidence.

30(b). The *Ireland* case involved two important facts not present here. In that case, the plaintiff had obtained *three* successive court orders compelling discovery before the district court ordered Rule 37(b) sanctions,[15] and the district court had found as an alternative ground for its jurisdiction that the defendants had sufficient minimum contacts with the forum state.

The relief sought would be dramatic. I have now concluded that defendants do have a Fourteenth Amendment right not to be burdened with suit in this jurisdiction. In that setting, a court would only with great restraint nevertheless attempt to subject defendants to its process based upon a Rule 37 sanction. If it were to be done, sound discretion would suggest that it only be done in cases of repeated or outrageous behavior. While one can understand why plaintiffs have brought this motion forward, the conduct does not, in my opinion, warrant the penalties they seek. This court has previously been wary of imposing jurisdictional sanctions on a defendant without first requiring that the plaintiffs move for an order compelling discovery under Del. Ch. 30(a). *See Andresen v. Bucalo*, Del. Ch., C.A. No. 6372 (Dec. 2, 1982); *Weinshchel Eng'g Co. v. Midwest Microwave, Inc.*, Del. Ch., 297 A.2d 443 (1972).

* * *

For the foregoing reasons, moving defendants' motion to dismiss is granted and plaintiffs' Rule 37 motion is denied. It is so ordered, this 28th day of May 1992.

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## KAHN v. TREMONT CORP.

No. 12,339

*Court of Chancery of the State of Delaware, New Castle*

August 21, 1992

Plaintiff brought this derivative action to challenge the fairness to Tremont Corporation of a transaction in which it purchased from

15. The Federal Rule of Civil Procedure 37(b) and the Delaware Chancery Rule 37(b) are substantially identical in language.

Valhi, Inc., its forty-four percent stockholder, a fifteen percent stock interest in another corporation. Plaintiff alleged that a majority of the directors of Tremont were also directors of Valhi; and, therefore, a conflict of interest existed with respect to this transaction. Plaintiff also alleged that defendant Simmons controlled Valhi and was, therefore, able to personally pick Tremont's Board of Directors. For these reasons, no pre-suit demand was made by plaintiff. Shortly after defendants answered, plaintiff filed a broad request for the production of documents. Under consideration was defendant's motion to stay discovery.

The court of chancery, per Chancellor Allen, denied the motion to stay discovery but did place limitations on discovery. The court found that the defendants' motion raised factual questions that were not raised by the complaint. Therefore, the court held it necessary to conduct additional discovery, but limited initial discovery to the question of director independence.

1. Pretrial Procedure ⟹19

A trial court maintains the power to supervise the discovery process in cases pending before it. A part of the exercise of that responsibility entails the granting of stays of discovery in appropriate circumstances.

2. Corporations ⟹319(5)

A motion challenging the standing of plaintiff to prosecute a derivative claim will, in the first instance, be addressed to the face of the complaint.

3. Corporations ⟹299, 314(1)

The independence of the members of a special committee is a question of fact that turns not simply upon formality but upon the reality of the interests and incentives affecting the independent directors.

4. Corporations ⟹211(2), 314(2)
Pretrial Procedure ⟹17

Where a plaintiff alleges that an interested transaction has been authorized and alleges a factual basis to conclude that the board of

the company is comprised predominately of persons whose judgment would be affected by conflicting interests, plaintiff plainly should have the right to discover into answering facts, relating to the alleged effectiveness of action of any independent committee of directors who are relied upon to protect the proponents of that transaction from justifying the fairness of its terms.

5. Corporations ⟹211(2), 314(2)
Pretrial Procedure ⟹17

When a plaintiff can allege with sufficient particularity that a transaction with an arguably controlling shareholder was authorized by a board composed predominately of persons with a conflicting interest, and an independent committee's action is set forth as an answer to that claim of interest, fairness to plaintiff and due regard for the proper administration of the derivative remedy dictates that limited discovery into the independence of the committee is appropriate.

Joseph A. Rosenthal, Esquire, of Rosenthal, Monhait, Gross & Goddess, P.A., Wilmington, Delaware; and Silverman, Harnes, Obstfeld & Harnes, New York, New York, of counsel, for plaintiff.

Jesse A. Finkelstein, Esquire, and David L. Finger, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; Timothy R. McCormick, Esquire, and Joseph D. Cohen, Esquire, of Thompson & Knight, Dallas, Texas, of counsel, for defendants Richard J. Boushka, Thomas P. Stafford, Avy H. Stein, and Tremont Corporation.

Henry N. Herndon, Jr., Esquire, and Kent A. Jordan, Esquire, of Morris, James, Hitchens & Williams, Wilmington, Delaware; and Donald E. Scott, Esquire, and Scott R. Bauer, Esquire, of Kirkland & Ellis, Denver, Colorado, of counsel, for defendants Susan E. Alderton, J. Landis Martin, Glenn R. Simmons, Harold C. Simmons, Michael A. Snetzer, and Valhi, Inc.

ALLEN, *Chancellor*

This derivative action challenges the fairness to Tremont Corporation of a transaction in which it purchased from Valhi, Inc., its 44% stockholder, a 15% stock interest in another corporation

(NL Industries, Inc.) controlled by Valhi. The claim is that the purchase was not in Tremont's interest, but was effectuated solely to advantage its stockholder, and was, as well, at an unfair price.

Defendants are Valhi, Inc. and the eight individuals who constitute Tremont's board of directors. No pre-suit demand to institute the suit was made, plaintiff alleging, *inter alia*, (1) that a majority of Tremont's board are directors or officers of Valhi or its affiliates other than Tremont and, for that reason, are in a conflict of interest position with respect to the underlying transaction; (2) that defendant Harold Simmons controls Valhi and "is able to hand pick" each of the directors of Tremont.[1]

Defendants answered in three pleadings, each of which denied the critical allegations of the complaint and asserted affirmative defenses. One pleading was filed on behalf of three directors who identified themselves as "the Special Committee"; one was filed on behalf of the Company and a third was filed on behalf of the remaining five directors and Valhi.

Shortly after the answers were filed, plaintiff filed a request for the production of documents. The document request was broad. Generally, it sought all documents referring or relating to (a) the tax consequences to Valhi of a series of recent transactions in the stock of Baroid Corporation and NL Industries; (b) the value of NL or its stock; (c) the Stock Purchase Agreement between Valhi and Tremont; (d) the consideration by Tremont of the Stock Purchase Agreement; (e) minutes of meetings of Tremont directors relating to the Stock Purchase Agreement; (f) Tremont's projected cash flows and capital expenditure requirements; (g) consideration of the Stock Purchase Agreement by a financial advisor of Valhi or of Tremont; (h) the financing by Tremont of the purchase; (i) any opinion or the possibility of any opinion by any investment bank or advisor with respect to fairness to Tremont of the Stock Purchase Agreement (or any purchase of NL shares); (j) any document evidencing or relating to any agreement between any member of the Special Committee and Mr. Simmons, Valhi or any person or entity under common control with Valhi; and (k) other requests.

Defendants then moved to dismiss the complaint for failure to comply with Rule 23.1 and moved to stay all discovery. The motion to dismiss has not yet been presented.

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1. Standing alone, this second allegation is plainly insufficient to excuse pre-suit demand under Rule 23.1. *See Aronson v. Lewis*, Del. Supr., 473 A.2d 805, 815 (1984); *Kaplan v. Cente Corp.*, Del. Ch., 284 A.2d 119, 123 (1971).

Before me at this time is the motion to stay discovery, but the motion to dismiss is relevant because in presenting that joint motion, all defendants assert factual matters beyond the matters alleged in the complaint. For the reasons that follow, I will deny the motion to stay discovery but will, in the exercise of my responsibility to supervise the litigation of claims before me, limit discovery as described below.

* * *

The complaint alleges that a majority of the board of Tremont is under a disabling conflict with respect to the purchase of NL stock from Valhi because a majority of Tremont directors are alleged to be directors of Valhi or of its NL affiliate. On its face, this pleading would seem plausibly to satisfy the applicable legal test to excuse demand. *See Aronson v. Lewis*, Del. Supr., 473 A.2d 805 (1984); *Heineman v. Datapoint Corp.*, Del. Supr., ___ A.2d ___ (Aug. 5, 1992). The answers admit the fact that a majority of Tremont's board is composed of persons who are also directors or officers of Valhi or its subsidiaries or affiliates other than Tremont.

The brief in support of the motion to dismiss, however, rests on new matters: that "three directors of Tremont . . . are not affiliated in any way with either Valhi . . . or NL." [It doesn't say that they are not affiliated with Mr. Simmons in some other way.] It asserts as a fact that on September 20, 1991, Tremont's board appointed these three individuals "as a Special Committee to analyze the proposed [purchase of NL shares from Valhi] on behalf of Tremont" (Opening Brief in Support of Motion to Dismiss at 3); and that the Special Committee engaged legal counsel and a financial advisor. *Id.* The brief appends minutes of an October 30, 1991 meeting of the Tremont board, which appear to evidence the receipt by the board of an oral report from the Special Committee to the effect that the proposed transaction was fair to Tremont and "in the best interests of the Company." The brief also asserts that NL stock was trading on the New York Stock Exchange at $12.75 at the time the Tremont board approved the $11.75 per share transaction.

* * *

I need not address the question whether pre-suit demand on a board of directors is excused where a majority of the board is sufficiently interested in a transaction to disarm the board of the presumption accorded by the business judgment rule but where a minority of the board is independent with respect to the transaction

involved. That question is not presented procedurally nor is the record developed with respect to facts relevant to it.

[1-2] Here I face only the question whether a stay of discovery is warranted. This is a question on which judgment is required. A trial court maintains the power to supervise the discovery process in cases pending before it, *Fish Eng'g Corp. v. Hutchinson*, Del. Supr., 162 A.2d 722 (1960). A part of the exercise of that responsibility entails the granting of stays of discovery in appropriate circumstances. 8 Wright & Miller, *Federal Practice & Procedures*: Civ. § 2040. Generally that means the court must balance the savings that may be gained by avoiding discovery (if defendant prevails on a case dispositive motion) against the risks associated with delay that may be visited upon plaintiff (in the event defendant loses its case dispositive motion). In all events, there is no hard and fast rule that affords to defendants a right to a stay simply because a case dispositive motion has been filed. *See, e.g.*, *Volge v. Anduser*, Del. Ch., C.A. No. 5639, Hartnett, V.C. (Aug. 29, 1978); *Schick Inc. v. Amalgamated Clothing & Textile Workers Union*, Del. Ch., C.A. No. 9066, Allen, C. (June 18, 1987). Thus, while the fact that a motion challenging the standing of plaintiff to prosecute a derivative claim will, in the first instance, be addressed to the face of the complaint,[2] *Aronson v. Lewis*, Del. Supr., 473 A.2d 805 (1984), may be conducive to a stay of discovery, it does not require one. *See Levine v. Smith*, Del. Supr., 591 A.2d 194, 209 (1991) (stay of discovery appropriate in a demand refused case).

* * *

In this instance it would be an error to stay discovery. Without prejudging the merits of defendants' motion to dismiss, I am unable to say that that motion appears to raise one or more factual questions not raised by the complaint. The complaint appears to plead a transaction authorized by a board that is predominantly subject to a conflicting interest. The answer made to that point appears to be that the board, in fact, took action at the recommendation of a disinterested committee and by a vote that was not numerically dominated by those with an interest.

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2. I say in the first instance because when the pleading itself is sufficient to excuse pre-suit demand, defendants are, of course, still free to show on summary judgment by uncontradicted facts that the allegations made are untrue and there is, therefore, no proper standing. Thus, a motion under Rule 23.1 to disable plaintiff from pursuing derivative litigation can be decided on the complaint or on affidavits.

This may be so, and, if so, those facts may have the legal effect that defendants assert, but unquestionably in advancing this position defendants seek to rely upon facts beyond those pleaded in the complaint. It would, in my view, be an affront to very basic standards of our system of justice to accept the few additional facts that defendants present as being not only true, but as being the only facts relevant to the question of the actual independence of the Special Committee.

[3-4] In all events, the independence or not of the members of a Special Committee is a question of fact that turns not simply upon formality but upon the reality of the interests and incentives affecting the independent directors. When a plaintiff alleges that an interested transaction has been authorized and alleges a factual basis to conclude that the board of the Company is comprised predominantly of persons whose judgment would be affected by conflicting interest, plaintiff plainly should have the right to discover into the answering facts, relating to the alleged effectiveness of action of any independent committee of directors who are relied upon to protect the proponents of that transaction from justifying the fairness of its terms. *Cf. Zapata Corp. v. Maldonado*, Del. Supr., 430 A.2d 779, 788 (1981) (discovery may be allowed in demand excused cases where independent committee seeks dismissal).

But I do conclude that it is appropriate in this case (where plaintiff can suggest no special injury from delay) to focus discovery initially on the question of the Special Committee's independence and thus to limit plaintiff's discovery to matters that may bear upon the interests, motivations or incentives implicated by the assignment undertaken by the members of the Special Committee.

This limitation, of course, may be inefficient. Depositions of relevant individuals may need to be repeated if defendants do not ultimately prevail on their motion. But it may save time and effort if defendants do prevail and, in all events, I see no way to avoid the risk of inefficiency and still afford to plaintiff a reasonable opportunity to test the factual predicate of the defendants' motion: that the Special Committee was, in fact, independent.

* * *

[5] The device of the Special Committee of the board is one that has in recent years come to be widely employed. There is great utility in this device. In some instances, it appears to have served effectively to permit the board to function in the corporation's interest, even though senior management was adverse to the corporation with respect to the transaction in question. *See, e.g., In re RJR Nabisco,*

*Inc. Shareholders Litig.*, Del. Ch., C.A. No. 10,389, Allen, C. (Jan. 31, 1989). In other instances the form of an independent committee seemed to mask an ineffectual or corrupted effort. *See, e.g., Mills Acquisition Co. v. Macmillan, Inc.*, Del. Supr., 559 A.2d 1261 (1989); *In re Trans World Airlines, Inc. Shareholders Litig.*, Del. Ch., C.A. No. 9844, Allen, C. (Oct. 21, 1988). The processes of adjudication of corporate disputes, while mindful of the special risks and costs associated with derivative litigation, must be sufficient to detect and distinguish these two situations that involve arguably independent board committees. Whether the operation of a Special Committee will be deemed to qualify a transaction for the ordinary presumption that attached to the action of a disinterested board should, in my opinion, turn on a specific evaluation of the facts of the case. At least when plaintiff can allege with sufficient particularity that a transaction with an arguably controlling shareholder was authorized by a board composed predominately of persons with a conflicting interest, and an independent committee's action is set forth as an answer to that claim of interest, fairness to plaintiff and due regard for the proper administration of the derivative remedy dictates, in my opinion, that limited discovery into the independence of the committee is appropriate.

The motion to stay will, therefore, be denied.

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## KOCH v. STEARN

No. 12,515

*Court of Chancery of the State of Delaware, New Castle*

July 28, 1992

Defendant was one of four directors, as well as the president and chief executive officer, of plaintiff corporation which was in financial trouble. Plaintiff corporation received two capital investment offers; one from an unrelated third party and the other from plaintiff Koch, also a director, who demanded the resignation of the defendant as president and CEO if his offer was accepted. Defendant received a letter April 6, 1992, requesting his presence at an April 7, 1992,

board meeting to discuss the financial condition of plaintiff corporation and the unrelated party's offer. At the meeting, according to the agenda of the other three directors, defendant was removed as president and CEO of the plaintiff corporation and an executive committee was established. On April 7, 1992, a fifth director was elected by plaintiff Koch pursuant to the amended certificate of incorporation. A determination of the validity of these actions was sought by plaintiffs and disputed by defendant.

The court of chancery, per Vice-Chancellor Berger, held that the actions taken at the April 7 meeting were void and of no effect because defendant was tricked into attending the meeting and was disadvantaged in his ability to participate meaningfully in the meeting, since the other directors misled and misinformed defendant as to their agenda for the April 7 board meeting. The court further held that the fifth director was validly elected on April 7, 1992, according to the court's interpretation of the amended certificate of incorporation.

1. Corporations ⟹298(3), 298(4)

When a corporate director is tricked or deceived into attending a board meeting, the general rule is that actions taken at such meeting are void.

2. Corporations ⟹298(3), 298(4)

Notwithstanding any deceit that may have been involved in calling a board meeting, the actions taken at such meeting will not be invalidated where the deceived director remains at the meeting and participates throughout.

3. Corporations ⟹298(3), 298(4)

Notwithstanding any deceit that may have been involved in calling a board meeting, the actions taken at such meeting will not be invalidated where the deceived director suffers no disadvantage in his ability to participate meaningfully in the meeting.

Michael Hanrahan, Esquire, and April Caso Ishak, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware, for plaintiffs and third-party defendants.

Lewis H. Lazarus, Esquire, Joseph R. Slights, III, Esquire, and Bruce C. Doeg, Esquire, of Morris, James, Hitchens & Williams, Wilmington, Delaware, for defendant, counterclaimant, and third-party plaintiff.

BERGER, *Vice-Chancellor*

This is the decision after an expedited trial in an action brought pursuant to 8 *Del. C.* §225 to determine the officers and directors of Showcase Communications Network, Ltd. ("Showcase"). Immediately prior to a board meeting held on April 7, 1992, there were four members of Showcase's board of directors: Leathem S. Stearn ("Stearn"), Jerome Ginsberg ("Ginsberg"), David H. Koch ("Koch") and George Bunn ("Bunn"). Stearn was also the company's president and chief executive officer. As the result of action taken at the April 7th meeting, Stearn was removed as president and chief executive officer and was replaced by Ginsberg. In addition, Koch elected a fifth director, William R. DeSena ("DeSena"). The complaint, filed by Koch and Showcase, seeks an order validating both of those actions taken at the April 7th meeting. In his third-party complaint, Stearn seeks the opposite determination and also asks the Court to rule that an Executive Committee purportedly established at the April 7th meeting was not validly created.

I.

Showcase is a Delaware corporation that was co-founded by Stearn and Arthur W. Clausen, Jr. ("Clausen") in 1990. The company was created to develop and market a computerized information service for the entertainment and modeling industries. The product, which has not yet generated significant revenues, is a system of hardware and software that is capable of creating a multimedia database of information about aspiring models and actors. Talent or modeling agencies who use the system are able to designate the characteristics and/or abilities they are looking for, and the system will retrieve information about every person in the database who meets those specifications.

Stearn, Clausen and Ginsberg were the three original stockholders and directors of Showcase. Stearn and Clausen constituted the management, and Ginsberg provided $100,000 in working capital. Almost immediately after the corporation was formed, Showcase

attempted a private placement of senior convertible preferred stock in an effort to raise $1.5 million in working capital. Stearn asked Koch to invest but Koch declined, in part because of Clausen's sudden departure from the company and the instability that resulted. One year later, however, Koch agreed to invest $2 million—the amount, according to Showcase's projections, that would be needed to carry the company until its revenues would at least equal its expenses. After several months of negotiations, the parties entered into a Purchase Agreement dated September 27, 1991, pursuant to which Koch acquired 2 million shares of Showcase Series A Preferred Stock.

As part of the transaction, Showcase's certificate of incorporation was amended to authorize the issuance of the preferred stock and specify its rights and preferences. The Certificate of Amendment (the "Amended Certificate") provides that the holders of the common stock and the preferred stock, voting separately as a class, are entitled to elect two of the four Showcase directors. In addition, Section 3(b)(i) provides that the holders of the preferred stock may elect a fifth director under certain circumstances:

> If the corporation shall (A) take any action specified in Section 3(c) without having first obtained the affirmative vote or the written consent of the holders of Preferred Stock specified in Section 3(c), or (B) fail to pay the redemption price in respect of shares of Preferred Stock specified in Section 4 on any redemption date, and such failure shall not have been cured without 10 days following receipt by the corporation of written notice of such failure from any holder of Preferred Stock, then the number of directors constituting the Board of Directors shall thereupon, without further action, be increased by one, and the holders of the Preferred Stock shall have, in addition to the other voting rights set forth in this Section 3, the exclusive right, voting separately as a single class, to elect such additional director of the corporation before any further action is taken by the Board of Directors.

Px. 44. Section 3(c) lists twenty actions that the corporation is prohibited from undertaking without the prior affirmative vote or written consent of a majority of the preferred stock. Those negative covenants prohibit, for example, the issuance of stock and declaration or payment of dividends except in certain circumstances; the sale or other disposition of all or substantially all of the assets of the company

or any subsidiary; the entry into employment, severance or consulting contracts; and the expenditure for fixed or capital assets of more than $100,000 in any fiscal year.

As a result of Koch's investment, there were four directors on the Showcase board: Koch, Bunn, Stearn and Ginsberg. Bunn, an attorney, was Koch's designee on the board, and Ginsberg, who had been serving on the board prior to Koch's involvement, became Stearn's designee. Stearn continued as president and chief executive officer of Showcase, and Christopher C. Cline ("Cline") was elected as vice president of finance and administration and secretary of the company.

In December 1991, Koch was becoming concerned about the fact that Showcase had not yet begun generating revenues and, instead, was using up its working capital at an excessive rate. By February 1992, it was apparent to all the board members that Showcase was running out of funds. The financial situation became more critical by late March, at which point the company was about to become insolvent. Stearn, who had been looking for funding sources for some time, received a written offer from Ira Shapiro ("Shapiro") to provide $250,000 of interim financing conditioned upon, among other things, receiving a first security interest in all of Showcase's assets. Stearn circulated the Shapiro offer to the other board members and requested an emergency board meeting to consider the proposal.

On March 27, 1992, before the emergency meeting was held, Koch offered to invest an additional $2 million subject to several conditions, the most significant of which was Stearn's immediate resignation as president and chief executive officer. The Koch offer was transmitted to Stearn in a letter from Bunn. That letter made it clear that both Bunn and Ginsberg supported the offer and advised Stearn that he must respond no later than March 30, 1992. The Koch offer was rejected by Andrew A. Levy, Esquire ("Levy"), Showcase's attorney.

The Showcase board met on March 31, 1992, to consider the company's alternatives. The Shapiro offer of $250,000 was considered and rejected, in part because the amount offered was insufficient and in part because Shapiro demanded a lien on all of Showcase's assets. Stearn mentioned other possible sources of financing, but had no firm offers to present to the board other than that made by Shapiro. The three outside directors again endorsed the Koch offer as being the most attractive proposal available to the company. They again expressed their belief that Stearn's removal would be required

to ensure the viability of the company. Although Stearn continued to oppose the Koch offer, Koch extended his offer until 6:00 p.m. on April 2, 1992.

During the course of the March 31st meeting, there was also a discussion about Koch's right to elect a fifth director. Bunn noted that, as of the date of the meeting, Koch had the power to elect a fifth director and thereby take control of Showcase. However, as reported in the minutes, "at this point in time Mr. Koch did not want to take these kinds of actions without the consent of Mr. Stearn." Px. 52, at 4.

The April 2nd deadline passed without Stearn accepting Koch's offer. The next day, Koch and Bunn discussed holding a board meeting at which Stearn would be removed from office. On the morning of April 6, 1992, Bunn faxed a letter to Levy that included a request that Stearn and Levy attend a board meeting the following morning. The letter stated, in relevant part:

> In view of the pending offer from Shapiro, and the dire financial condition of Showcase, David [Koch], Jerry [Ginsberg] and I hope that you and Leathem [Stearn] can attend a meeting at Davids' [sic] office at 9:00 a.m. tomorrow morning to review the situation. David has asked Mr. Shapiro to extend his offer until we have had a chance to discuss the situation. Since there is no time for formal notice, the four directors would waive notice at the 9:00 a.m. meeting tomorrow. Please advise immediately.

Px. 27. Later in the day, Bunn sent Koch and Ginsberg draft resolutions to consider for the meeting the next morning. Those resolutions, which included the removal of Stearn, were not circulated to Stearn or Levy.

Not surprisingly, there is some dispute as to what occurred at the April 7th board meeting. The four directors and Levy were present at the start of the meeting at approximately 9:00 a.m. The first order of business, according to Bunn, was to have each director waive notice of the meeting. The three outside directors all recall that being done, whereas Stearn and Levy have no such recollection.

There is agreement that the next item of business concerned the minutes. There had been correspondence between Bunn and Levy over the accuracy of Levy's version of the minutes of the March 31st meeting. With that in mind, Bunn announced that he would keep the minutes of the April 7th meeting. Stearn and Levy both objected, but the three outside directors voted in favor of Bunn

keeping the minutes. It is not clear whether Stearn actually voted no or remained silent.

The next order of business concerned the different versions of the March 31st board meeting minutes. Bunn proposed that his version be adopted, and again Levy and Stearn objected. There was some discussion about the accuracy of the two sets of minutes, and Stearn complained that he should be given an opportunity to review Bunn's version in detail. Bunn called for a vote, and the three outside directors voted to adopt Bunn's version of the March 31st board meeting minutes.

Stearn claims that he demanded Ginsberg's resignation from the board before the vote on the March 31st minutes was complete. All of the other directors and Levy recall Stearn making that announcement later in the meeting. According to Bunn, after the minutes were approved there was discussion of several business matters including the status of negotiations with Kodak and the liquidation value of the company. Bunn then asked Stearn whether he had reconsidered Koch's offer as set forth in the March 27th letter. When Stearn said no, Bunn proposed a resolution to remove Stearn as president and chief executive officer and to replace him with Ginsberg. Koch seconded the motion, and the three outside directors voted in favor of it.

The vote, however, did not settle matters. According to Bunn, both Stearn and Levy were agitated, claiming for example, "You can't do this." Bunn says that it was at this point that Stearn announced his decision to remove Ginsberg as a director. Bunn advised Stearn that he could not remove Ginsberg without a written consent from Stearn as the holder of more than 50% of the common stock, and nothing further was done to resolve that issue. Immediately after this exchange, Bunn says that he proposed a resolution creating an executive committee followed by another resolution authorizing the company to engage Delaware counsel and file this action. Both resolutions were approved promptly by the three outside directors. There is some dispute as to whether Stearn voted, expressed opposition in some other fashion, or remained silent. In any event, his own notes of the meeting establish that Stearn was still there when those votes were taken.

At some point during the meeting either Bunn or Koch announced that Koch was appointing a third director under the power granted to him in Article Fourth of the Amended Certificate. Levy recalls questioning Bunn as to the specific covenants Stearn purportedly violated, thereby giving rise to Koch's power to appoint a

fifth director. Both Bunn and Levy testified that Bunn did not provide much specific information in response to that question. Before the participants departed, there was also some discussion of the Shapiro offer (which had been amended to delete the lien on all company assets). However, it is not clear whether that discussion took place during the meeting, as the outside directors suggest, or after the meeting as some of the participants were departing.

II.

[1-3] The validity of the board action taken on April 7th, whereby Stearn was removed from office and replaced by Ginsberg, depends upon whether Stearn was tricked or deceived into attending the meeting.[1] If so, the general rule is that actions taken at such a meeting are void. *Schroder v. Scotten, Dillon Co.*, Del. Ch., 299 A.2d 431, 436 (1972). Notwithstanding any deceit that may have been involved in calling a meeting, the actions taken will not be invalidated where the deceived director remains at the meeting and participates throughout, *Dillon v. Berg*, D. Del., 326 F. Supp. 1214, 1221, *aff'd*, 453 F.2d 876 (1971), or where that director suffers no disadvantage in his ability to participate meaningfully in the meeting. *Pepsi-Cola Bottling Co. of Cincinnati v. Woodlawn Canners, Inc.*, Del. Ch., C.A. No. 6161, Brown, C. (Mar. 14, 1983), slip op. at 28-29.

Plaintiffs argue that Stearn was not tricked or deceived into attending the April 7th meeting. Koch's March 27th offer of $2 million was contingent upon Stearn stepping down, and Stearn knew that the other directors supported the Koch proposal. He also knew that Showcase was in "dire financial condition" and that one source of needed funds was Koch. Thus, according to plaintiffs, Stearn knew or should have known that his removal from office, consistent with Koch's investment offer, might be one of the subjects of the meeting. Indeed, Stearn and Levy discussed this possibility indirectly. Stearn asked Levy whether he should remove Ginsberg before the

1. At the outset, there was an issue as to whether Stearn waived the ten-day notice requirement for the calling of a special board meeting. It is not clear whether Stearn is still pressing this argument. However, if he is, I find in favor of plaintiffs. First, I believe the testimony of the other directors that all directors were asked to waive notice at the beginning of the meeting and that they all did so. Moreover, even if there was no express waiver given, Stearn attended the meeting and did not object at the beginning to the lack of notice. For these reasons, I find that the ten-day notice requirement was waived. *See* 8 *Del. C.* §229; Px. 54, at 12-13.

meeting. Levy advised that he did not think such action was necessary, and Stearn made the tactical decision to leave Ginsberg on the board notwithstanding the fact that Ginsberg had already supported Stearn's ouster.

Although I agree that Stearn may have had some reason to suspect that his removal from office would be discussed on April 7th (as it was on March 31st), I find that he was tricked into attending the meeting. The letter to Levy suggested that the board would be considering the revised Shapiro offer. It was silent as to any possible consideration of the Koch offer, which had technically expired. Moreover, the outside directors had an agenda, which included removing Stearn from office if he did not cooperate and step down voluntarily. I cannot help but conclude that Bunn's failure to inform Stearn of this agenda item was intentional. Finally, Bunn's own testimony supports the conclusion that Stearn was tricked. In describing how Stearn reacted to the resolution calling for his removal, Bunn testified: "[Stearn] shook his head and was very agitated that he was—he was obviously startled. He apparently hadn't suspected it, because he was very agitated. . . . He was stammering. He was obviously shaken by what had just happened. He said, 'Well then . . . .'—[H]e was kind of stuttering." Trans., p. 70.

Having found that Stearn was tricked into attending the April 7th meeting, the next question becomes whether he stayed and participated in the meeting or, if he did not, whether he was disadvantaged. Stearn testified that he withdrew from the meeting as soon as the three outside directors voted to have Bunn keep the minutes. At that point, Stearn claims to have begun packing up to leave. I find this testimony incredible, inasmuch as Stearn was still there when the meeting ended and he had taken notes throughout. However, it appears that Stearn did not vote or otherwise participate in the meeting after the resolution calling for his removal from office was presented. Alternatively, I find that Stearn was disadvantaged by the other directors' failure to communicate their plans to him. If Stearn had seen the draft resolutions before the meeting, he could have exercised his right to remove Ginsberg as a director and he could have replaced Ginsberg with another nominee who would vote with Stearn to block Stearn's removal. Without doubt, Stearn's inability to thus protect himself constituted a disadvantage. Thus, I conclude that the actions taken at the April 7th board meeting were void and of no effect.[2]

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2. In reaching this conclusion, I am not unmindful of the fact that Koch

III.

The next issue is whether DeSena was validly elected as a fifth director pursuant to Article Fourth of the Amended Certificate. As noted earlier, Section 3(c) of Article Fourth lists twenty negative covenants and Section 3(b)(i) authorizes the holders of the preferred stock to elect a fifth director if the actions described in the covenants are undertaken without the prior affirmative vote or written consent of the preferred stockholders. Thus, the first question is whether Koch established that one or more of the negative covenants was violated. For the reasons that follow, I find that one violation has been established.

Section 3(c)(xiv) prohibits expenditures for fixed or capital assets in excess of $100,000 during any fiscal year. Cline, Showcase's Chief Financial Officer, testified that Showcase acquired more than $100,000 of capital assets during the fiscal year ending March 31, 1992. He prepared a schedule showing total expenditures of over $300,000, and Cline testified that the vast majority of the entries on that schedule were for computer hardware and other equipment (as opposed to computer software, which may or may not be considered a capital asset). Cline's testimony and schedule, which were unrebutted, establish a violation of Section 3(c)(xiv).

The next issue is whether Koch was required to give Showcase notice and an opportunity to cure this violation of Section 3(c). Koch argues that Section 3(b) is unambiguous and that the notice and cure provision applies only to the corporation's failure to pay the redemption price on a redemption date. Stearn argues that the notice and cure provision applies to both Section 3(c) violations and the failure to pay the redemption price.

After a careful review of the relevant language, I am satisfied that it is not ambiguous and that the notice and cure provision does not apply to violations of Section 3(c). *See Flerlage v. KDI Corp.*, Del. Ch., C.A. No. 8007, Hartnett, V. C. (Apr. 10, 1986), slip op. at 11. The Amended Certificate states: "If the corporation shall (A) take any action specified in Section 3(c) . . . , or (B) fail to pay the redemption price . . . on any redemption date, and such failure shall not have been cured within 10 days following . . . written notice

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had the ability, under certain circumstances, to elect a fifth director and then to remove Stearn by vote of the expanded board. However, Koch had not exercised that right prior to the April 7th meeting. Thus, as matters stood on the morning of April 7th, Stearn was in a position to block any unfavorable votes if he had known what was coming.

. . . , then the numbers of directors . . . shall . . . be increased by one . . . ."

By its terms, the notice and cure provision applies to "such failure," and the only "failure" identified in the prior clauses is the failure to pay the redemption price. The Section 3(c) violations are not described as "failures" and, in fact, are largely, if not entirely, affirmative actions (e.g., the issuance of securities, the declaration and payment of dividends, the entry into a joint venture, the transfer or disposition of assets, etc.). Thus, from a strictly technical reading of the provision in question, one must conclude that the notice and cure requirement applies only to the failure to pay the redemption price.

A substantive analysis of Section 3(c) violations also supports this result. How can one cure the issuance of stock or sale of assets to a third party or the entry into a joint venture or an employment contract? Moreover, the activity prohibited by Section 3(c) is only prohibited if undertaken without first obtaining the affirmative vote or written consent of the preferred stockholders. It would be somewhat inconsistent to require prior consent and to allow an opportunity to cure with respect to the same conduct. In sum, the contested provision is not only clear, but also entirely consistent with the other sections of the Amended Certificate. Accordingly, I find that Koch was not required to give Stearn or Showcase notice or an opportunity to cure any Section 3(c) violations before appointing a fifth director.

Based upon the foregoing, I find that Stearn was not validly removed as president and chief executive officer at the April 7th board meeting and that the Executive Committee was not validly established. I also find that DeSena was validly elected as a fifth director of Showcase on April 7, 1992. IT IS SO ORDERED.

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## MARHART, INC. v. CALMAT CO.

No. 11,820

*Court of Chancery of the State of Delaware, New Castle*

August 19, 1992

Defendant corporation and its named directors motioned for reargument of their motion to dismiss plaintiff's complaint alleging

that defendants breached their fiduciary duty through the issuance of press releases that misrepresented defendant's restructuring plans. Defendants asserted that there was no legal precedent for the fiduciary duty of full disclosure; and even if such a duty existed, plaintiff lacked standing because the alleged breach took place before plaintiff was a stockholder; and/or the complaint failed to state a claim as it did not allege knowing misrepresentations.

The court of chancery, per Vice-Chancellor Berger, denied defendant's reargument. The court held that the legal precedent for the fiduciary duty of disclosure and the equitability of plaintiff's claim were both previously considered and inappropriate for reargument. Further, defendant's assertion that plaintiff was not a stockholder could be raised in additional motions under appropriate circumstances but could not be considered on a motion for reargument.

1. Appeal & Error ⟹828

Reargument generally will be granted only if it appears that there is some decision or some principle of law which would have been overlooked or there has been a misappreciation of the law or of the facts that would change the outcome of the decision; the motion is not designed to accommodate a reargument of matters which were previously considered and determined.

2. Corporations ⟹307

Fiduciaries, who undertake the responsibility of informing stockholders about corporate affairs, are required to do so honestly.

3. Corporations ⟹307

Fiduciary duties run to stockholders, not prospective stockholders.

Michael Hanrahan, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware, for plaintiff Marhart, Inc.

R. Franklin Balotti, Esquire, of Richards, Layton & Finger, Wilmington, Delaware, for defendant Clamat Co. and individual defendants.

Edward P. Welch, Esquire, of Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware, for individual defendants.

BERGER, *Vice-Chancellor*

Calmat Company ("Calmat") and its named directors moved for reargument of this Court's decision denying their motion to dismiss for lack of subject matter and personal jurisdiction. *See Marhart, Inc. v. Calmat Co.*, Del. Ch., C.A. No. 11,820, Berger, V.C. (Apr. 22, 1992). In that opinion, the Court found that plaintiff's class action complaint sufficiently stated an equitable claim for breach of the fiduciary duty of full disclosure and, thus, the Court denied defendants' motions to dismiss. The alleged breach involved the issuance of press releases that misrepresented defendants' restructuring plans.

[1] Defendants assert three grounds for reargument. First, they maintain that there is no legal precedent for the fiduciary duty of full disclosure as found by this Court in its earlier opinion. Second, they argue that even if such a duty exists, plaintiff lacks standing because the alleged breach took place before plaintiff was a stockholder. Finally, defendants contend that the complaint fails to allege knowing misrepresentations and, thus, fails to state a claim.

Reargument generally will be granted only if:

> it appears that there is some decision or some principle of law which would have a controlling effect and which has been overlooked or there has been a misapprehension of the law or of the facts that would change the outcome of the decision. The motion is not designed to accommodate a reargument of matters which were previously considered and determined.

*Merrill Lynch Pierce Fenner & Smith, Inc. v. Shin*, Del. Ch., C.A. No. 7424, Longobardi, V.C. (June 13, 1984), ltr. op. at 2 (citations omitted). Defendants' arguments concerning the existence of a fiduciary duty of full disclosure under the circumstances presented and the adequacy of the allegations both were raised previously and considered by the Court. Thus, reargument does not appear appropriate as to those contentions. The remaining argument, concerning plaintiff's status as a stockholder, was raised for the first time in this motion.

[2-3] To the extent that defendants seek clarification, this will confirm that, in its earlier decision, this Court did not extend the

fiduciary duty of full disclosure to nonstockholders. The Court focused on the distinction between disclosures made to stockholders at a time when stockholder action is being requested and disclosures made to stockholders at other times. The Court concluded that "fiduciaries who undertake the responsibility of informing stockholders about corporate affairs [are] required to do so honestly." *Marhart*, C.A. No. 11,820, slip op. at 6. There is nothing in this Court's earlier decision concerning disclosures to nonstockholders and, as defendants note in their motion for reargument, fiduciary duties run to stockholders, not prospective stockholders. *Anadarko Petroleum Corp. v. Panhandle E. Corp.*, Del. Supr., 545 A.2d 1171 (1988).

Defendants apparently seek this clarification because information not contained in the complaint indicates that Marhart, Inc. was not a stockholder at the time the allegedly false press releases were issued. If that is factually correct, defendants may pursue whatever additional motions are appropriate under the circumstances and, one would imagine, plaintiff could seek leave to add an additional party who was a stockholder to act as class representative. Those matters will not be considered on the present record, however, as part of a motion for reargument.

Based upon the foregoing, defendants' motion for reargument is denied.

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## ROTHENBERG v. SANTA FE PACIFIC CORP.

No. 11,749

*Court of Chancery of the State of Delaware, New Castle*

May 18, 1992

Plaintiff, suing individually and on behalf of a class of defendant's stockholders, alleged that the defendant's directors breached certain fiduciary duties in modifying an exchange offer. The modification retroactively reduced the floor exchange value of common stock which had been distributed pursuant to the original floor exchange value. Consequently, 1,150,000 additional shares of common stock were distributed for no additional consideration. Moreover,