plaintiffs received regularly were so suggestive of mismanagement.[66] Whether accompanied by optimistic projections or not, these discrepancies alone were sufficient notice of wrongdoing to prompt inquiry into the Partnerships. Upon receipt for each Partnership of the first annual report revealing cash distributions in excess of net income, plaintiffs were on inquiry notice of their claims.[67]

IV. CONCLUSION

[21] On the basis of this record, I conclude that the information in the annual reports alone should have provided plaintiffs with adequate notice of any alleged misconduct by defendants.[68] Based on the facts alleged in the

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[66]*See, e.g., Playtex, Inc. v. Columbia Casualty*, Del. Super., C.A. No. 88C-MR-233, at 7, Del Pesco, J. (Sept. 20, 1993) ("inherently unknowable" theory of tolling did not apply where a "wealth of information regarding [the cause of action] was generally available" when the fraud occurred); *Halpern*, 313 A.2d at 143 (statute is tolled only for the "period of fraudulent concealment").

[67]*See Ruger v. Funk*, op. at 6 ("Actual discovery surely commences the running of the statute; so will any change in circumstances that renders the injury no longer inherently unknowable, or the ignorance of the party-plaintiff no longer blameless.").

The Amended Complaint also alleges that such "deceptive" cash distributions were used to promote the sale of later Partnerships, and the purchasers of the later Partnerships would have no reason to review the financial information/materials for the earlier Partnerships. Assuming this is true, it still should have been obvious to the investors soon after receiving their annual reports that the cash distributions *they* were receiving were inflated and not reflective of actual earnings. Perhaps for one year, this would not raise too much concern, but certainly after the second or third straight year of cash distributions that far exceeded Partnership income, accompanied by a commensurate decline in partners' capital, plaintiffs should have been aware that the cash distributions they were receiving were not the result of investment gains—and that they were most likely duped into purchasing the Partnerships in the first place. The inherent contradiction between the distributions-described in these annual reports as "annualized returns"—and the declining partners' capital and net income lower than the distributions should have caused plaintiffs to question whether the touted cash distributions of the earlier partnerships were truly indicative of profits. That is inquiry notice. *Queen Anne Pier Condominium Council v. Raley*, Del. Super., C.A. No. 85C-JA10, at 8, Lee, J. (Jan. 26, 1988) (inquiry notice means the existence of facts sufficient to put person of ordinary intelligence and prudence on inquiry which, *if pursued*, would lead to the discovery).

[68]Although I conclude that the glaring inconsistencies contained in the annual reports were sufficient, in and of themselves, to place plaintiffs on inquiry notice of their potential causes of action, those discrepancies were not the only indications plaintiffs had of their potential claims. I need not address them in substance (as I find the material in the annual reports dispositive on the issue), but I am inclined to agree with defendants' other assertions of plaintiffs' inquiry notice: (1) that plaintiffs were on notice no later than 1992, when defendants changed the format of their monthly account statements to reflect the true, rather than par, value of the Partnerships. *See In re Prudential Sec. Inc. L.P. Litig.*, 930 F. Supp. at 76-77; (2) that some investors in the Partnerships did manage to file lawsuits against the very same limited partnerships *before* January 26, 1996, suggests the alleged wrongful conduct was detectable by the average investor; and (3) that the *Wall Street Journal* article neither disclosed any concrete information about sales practices or the investments in question, nor mentioned by name the limited partnership defendants in this case, thus

Amended Complaint, drawing all inferences in favor of plaintiffs, I conclude that plaintiffs were clearly on inquiry notice of their claims long before February 6, 1993 (or before October 7, 1993, with regard to the Falcon Classic Cable claim).[69] The limitations period for this cause of action is three years. Plaintiffs' February 1996 filing (the earliest of plaintiffs' filings) comes *more* than three years after they were placed on inquiry notice. For these reasons, I grant defendants' motion to dismiss on the ground that the plaintiffs' claims are time-barred by operation of the statute of limitations.[70]

IT IS SO ORDERED.

FRANK v. ENGLE

Nos. 13,323 & 13,284

Court of Chancery of the State of Delaware, New Castle

March 25, 1998

Plaintiffs brought a motion to compel production of various documents they had requested in the course of shareholder derivative suits (consolidated for purposes of discovery). Defendants refused to produce the documents asserting that attorney-client privilege protected certain documents, and that plaintiffs' other requests were (1) not relevant to the conduct complained of in the pleadings; (2) overly broad, overly burdensome, and duplicative; or (3) in the possession of nondefendant affiliates.

The court of chancery, per Vice-Chancellor Steele, granted in part plaintiff's motion to compel production of documents and ordered the

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raising a serous doubt as to how the article alone could have prompted such an inquiry.

[69]*Cf. Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, Del. Ch., C.A. No. 13950, Allen, C. (Nov. 21, 1995) (motion to dismiss denied because issue of plaintiffs' inquiry notice was in dispute).

[70]Plaintiffs' request, in the alternative, to amend their Amended Complaint is hereby denied. No amendment would cure the fatal flaw in plaintiffs' current Amended Complaint—that it was filed too late. *Glaser v. Norris*, Del. Ch., C.A. No. 9538, at 30-31, Chandler, V.C. (Jan. 6, 1992) ("A court should deny leave to amend a complaint when the amendment would be futile due to the insufficiency of the proposed amendment.")

defendants to produce all documents that the plaintiffs requested excluding those possessed by nondefendant affiliates. The court found that requests for the latter documents were (1) overly broad, (2) duplicative, and (3) outside the scope of the complaint.

1. Pretrial Procedure ☞ 27, 31, 331, 351, 352

Parties may obtain discovery regarding any matter, not privileged, which is relevant to the subject matter involved in the pending action. DEL. CH. CT. R. 26(b).

2. Pretrial Procedure ☞ 19, 20

Rule 26 mandates a liberal approach, favoring production of all documents that might reasonably relate to the subject matter of the pending action. DEL. CH. CT. R. 26.

3. Pretrial Procedure ☞ 561, 562

The scope of Rule 26 is restricted by the practical application of the rule as well as the defendant's right to raise affirmative defenses. DEL. CH. CT. R. 26.

4. Pretrial Procedure ☞ 334, 337, 354

Documents requested in the course of discovery must be in the possession, custody, or control of the party upon whom the request is served. DEL. CH. CT. R. 34.

5. Pretrial Procedure ☞ 11, 23, 24, 334, 337, 354, 401

Document requests in the course of discovery are restricted to litigants in so far as the court can compel production only from those persons over whom the court can assert personal jurisdiction.

6. Pretrial Procedure ☞ 331, 334, 351, 352, 354

Document related discovery is limited in scope to production of documents relevant to the subject matter of the litigation, and within the control of a party to the action.

7. Pretrial Procedure ⇐ 11, 14, 17, 18, 19

In order to guard against discovery being used to overwhelm an opponent with the effort and cost of complying with overly broad document requests, Rule 26 directs the court to limit the range of discovery to what is reasonably necessary and to prevent duplicative, unduly expensive, unnecessary, or otherwise burdensome production. DEL. CH. CT. R. 26.

8. Pretrial Procedure ⇐ 17, 34, 561, 562

Rule 26's liberal policy is limited by the responding party's right to protect relevant documents, if circumstances allow responding party to raise affirmative defenses such as attorney-client privilege. DEL. CH. CT. R. 26.

9. Pretrial Procedure ⇐ 34, 561
Witnesses ⇐ 197, 198(1), 198(2)

Attorney-client privilege is an affirmative defense that protects communications between an attorney and client.

10. Pretrial Procedure ⇐ 34
Witnesses ⇐ 197, 204(2)

A party who successfully asserts attorney-client privilege can deny the other party access to otherwise relevant documents.

11. Courts ⇐ 97(1)
Pretrial Procedure ⇐ 13, 401, 411

In examining plaintiff's specific document requests, the court must balance plaintiff's need to examine documents pertaining to the alleged claims against defendant's right to refuse documents outside the scope of Rules 26 and 34, and to refuse production of protected documents. DEL. CH. CT. R. 26, 34.

12. Courts ⇐ 97(1)
Pretrial Procedure ⇐ 12, 13

Federal case law may be used to decide discovery issues that have never been evaluated by Delaware case law.

13. Pretrial Procedure ⇐ 34, 35, 357, 371
Witnesses ⇐ 201(1), 205

Unrebutted testimony that defendant corporation's secretary, an attorney, rendered no legal opinion concerning the contents of the board draft minutes during the minute finalization process, but merely waited for defendant's comments, is not the type of review which entitles defendants to assert attorney-client privilege.

14. Federal Civil Procedure ⇐ 1551, 1572
Pretrial Procedure ⇐ 331, 336, 352

The court has discretion to allow discovery of documents dated after the filing of the complaint, where the plaintiff's claim describes a pattern of conduct which defendants may be continuing, or where the documents may describe matters relevant to the events described in the complaint.

15. Pretrial Procedure ⇐ 14, 15, 16, 19, 20, 26, 27

Where a defendant in a derivative lawsuit makes little or no public disclosure, the court should be less reluctant to give plaintiffs wide latitude in the scope of their discovery.

16. Pretrial Procedure ⇐ 14, 15, 16, 19, 20, 26, 27

Where a defendant in a derivative lawsuit imposes an information blackout on shareholders by making little or no public disclosure, it is reasonable for the court to grant plaintiffs the opportunity to examine recent information pertaining to the continuing wrongs alleged in their complaint.

17. Pretrial Procedure ⇐ 336, 337, 355

Defendants are not obligated to respond to request for production of documents that would be duplicative and, therefore, wasteful or frivolous.

18. Pretrial Procedure ⇐ 331, 336, 352

Where the approval of a merger is alleged to constitute waste, documents that are created or acquired by the defendant after the decision to approve the merger are discoverable, if the documents may relate to the defendant's decision to approve the merger.

19. Pretrial Procedure ⇐ 352

Facts showing funds moved from the corporation, through a series of transactions among affiliates of the corporation, to the defendant's back pocket would be highly probative in a derivative action.

20. Corporations ⇐ 320(11)
Pretrial Procedure ⇐ 352

Plaintiffs' allegations that the target corporation's insurance subsidiary was in liquidation for making improper investments in the target corporation was not relevant to the derivative action, even though the subsidiary's financial improprieties may have affected the value of an asset of the target corporation, where plaintiffs do not allege the subsidiary is an alter ego of the target corporation.

21. Federal Civil Procedure ⇐ 1588, 1619
Pretrial Procedure ⇐ 334

The court can not compel production of documents from a firm that is not named in the suit, or that is not a wholly-owned subsidiary or alter ego of a named defendant.

22. Corporations ⇐ 310(11)
Federal Civil Procedure ⇐ 1572, 1588, 1617
Pretrial Procedure ⇐ 352, 377

In a derivative action, discovery pertaining to financial records of the corporation's affiliates is not relevant, overly broad, and duplicative where not needed to trace the defendant's use of corporate funds as related to plaintiff's claims.

23. Pretrial Procedure ⇐ 331, 351, 352

Court may order disclosure of a corporate fact book containing a list of employees with knowledge of issues raised in a derivative suit, thereby containing information reasonably related to the litigation.

24. Action ⇐ 6
Pretrial Procedure ⇐ 552

Plaintiff's demand that defendants describe all documents withheld on the grounds of being irrelevant, overly burdensome, or in the possession of a nondefendant affiliate, is moot where the defendant's answering brief states that no documents were refused solely on these grounds.

Kevin Gross, Esquire, of Rosenthal Monhait Gross & Goddess, P.A., Wilmington, Delaware; Biggs & Battaglia, Wilmington, Delaware; Silverman, Harnes & Harnes, New York, New York, of counsel; and Lowey Danenberg Bemporad & Selinger, White Plains, New York, of counsel, for plaintiffs.

Stephen E. Herrmann of Richards, Layton & Finger, Wilmington, Delaware, for defendants.

STEELE, *Vice-Chancellor*

Plaintiffs in these actions (consolidated for purposes of discovery) have filed derivative actions on behalf of Sunstates. The suit names as defendants Sunstates' CEO and controlling shareholder, Clyde Wm. Engle (Engle), the individual members of Sunstates' board, and three holding companies, Hickory Furniture Co. (Hickory), RDIS Corp. (RDIS), and Telco Capital Corp. (Telco). Engle controls Hickory, RDIS and Telco, which are parents of Sunstates. Plaintiffs allege that Engle, with the help of the Sunstates board and the parent companies, has engaged in a systematic looting of Sunstates by causing Sunstates to make bogus loans, engage in sham transactions, award undeserved bonuses, and waste its assets in sundry ways. Plaintiffs now seek an order compelling discovery of various documents pertaining to the alleged looting of their company. Some of the document requests are duplicative, and some ask for documents outside the scope of this litigation. However, I conclude that defendants have been remiss in not turning over other documents in their possession. I order defendants to turn those documents over now. For the reasons set forth below, plaintiffs' motion is ***granted in part; denied in part.***

I. Plaintiffs' Discovery Requests & the Court's Rulings

[1-3] In evaluating plaintiffs' requests for production of documents, the Court must follow the language in Court of Chancery Rule 26: "Parties may obtain discovery regarding any matter, not privileged, which is relevant to

the subject matter involved in the pending action." CH. CT. R. 26(b). The rule mandates a liberal approach, favoring production of all documents that might reasonably relate to the subject matter of the pending action. Nonetheless, Rule 26 is restricted in two fundamental ways--the rule's practical application and defendants' right to raise affirmative defenses.[1]

[4-6] The scope of Rule 26 is limited by the language of the rule itself and by supplemental rules pertaining to specific types of discovery. Rule 26 states that documents must be "relevant to the subject matter." And, under Rule 34 (which applies specifically to document production), the documents must be "in the possession, custody, or control of the party upon whom the request is served." "Party" as used in Rule 34 is not restricted in meaning to the litigants, but it is effectively so restricted because the Court can compel production only from those persons over whom the Court can assert personal jurisdiction.[2] Consequently, document discovery is limited in scope to production of documents (i) relevant to the subject matter of the litigation and (ii) within the control of a party to the action.[3]

[7] The scope of allowable discovery is limited further by the wide discretion allowed the Court. The Court's oversight is necessary because of the potential that a party will use discovery as an offensive weapon to overwhelm the opponent with the effort and cost of complying with overbroad document requests. To guard against this abuse, Rule 26 directs the Court to limit the range of discovery to what is reasonably necessary and to prevent duplicative, unduly expensive, unnecessary, or otherwise burdensome production.[4]

[8-10] The second limitation upon Rule 26's liberal policy is the right of the responding party to protect relevant documents, if the circumstances allow the responding party to raise an affirmative defense such as attorney-client privilege. Attorney-client privilege, the defense raised by defendants in this motion, protects communications between an attorney and client.[5] A

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[1]The analysis of Rule 26 applies to discovery in general, but the Court focuses on discovery of documents and affirmative defenses peculiar to that form of discovery.

[2]*See Rosenblatt v. Getty Oil Co.*, Del. Ch., C.A. No. 5278, mem. op. at 5, 6 DEL. J. CORP. L. 362, 364, Brown, V.C. (April 8, 1981) (holding that plaintiff could not compel defendant to produce affiliate's documents, but leaving open possibility that plaintiff seek subpoenas directly against nonparty affiliate).

[3]*Accord Camden Iron & Metal, Inc. v. Marubeni America Corp.*, 138 F.R.D. 438, 441-44 (D.N.J. 1991) (examining relevancy and control issues in document production and applying alter ego test to determine if U.S. subsidiary had control over Japanese parent's documents).

[4]CH. CT. R. 26(b)(1).

[5]*Brett v. Berkowitz*, Del. Supr., No. 479, 1996, slip copy at 9, ___ A.2d ___, ___, Veasey, C.J. (Feb. 27, 1998) (*en banc*) ("The main purpose behind the attorney-client privilege is 'to promote freedom of consultation of legal advisers by clients.'") (citing 8 WIGMORE, EVIDENCE § 2291, at 545 (McNaughton rev. 1961)).

party who successfully asserts attorney-client privilege can deny the other party access to otherwise relevant documents.

[11-12] In examining the plaintiffs' specific document requests, I must balance the plaintiffs' need to examine documents pertaining to the alleged claims against the defendants' right to refuse documents outside the scope of Rule 26 (and Rule 34) and to refuse production of protected documents. Delaware case law has evaluated many, but not all of the permutations the of discovery issues raised in this case. But, our discovery rules are fashioned after the rules used in the federal courts; and, therefore, I turn to that fountainhead of judicial wisdom to assist my analysis.

1. Draft Minutes

Plaintiffs request "draft" minutes for meetings of the Sunstates board and its committees.[6] In an earlier opinion deciding plaintiffs' first motion to compel, I denied plaintiffs' request for draft copies of board minutes. I reasoned that the finalized versions of these documents would adequately inform plaintiffs of what occurred at the meetings without compromising the board's right to edit and certify the content of its minutes privately, a process that normally relies on legal counsel.

Plaintiffs now argue that defendants have abused my order by not turning over "final" drafts. Instead, they contend, defendants have implemented a procedure for approving final drafts that purposefully delays discovery and affords Engle, the alleged mastermind of defendants' wrongdoing, the opportunity to tailor the minutes in light of this litigation. Plaintiff finds testimony by Sunstates' secretary, Richard Leonard, an attorney, significant in that he admits that he gave no legal opinions as to the content of the minutes, but merely waited for Engle to make his comments before finalizing the minutes and turning them over to plaintiffs. Engle's comments came years after the meetings, and apparently, were made just before the deadline for releasing the documents. According to plaintiffs, Leonard's role, which was to wait for Engle's comments, shows that the draft minutes should not be protected from discovery under a work product or attorney-client privilege theory, and that, furthermore, the finalization procedure is merely a charade.

Defendants decline to address the substantive arguments made by plaintiffs. Instead, in a cursory fashion, they state that the Court should not rehear an issue previously decided because plaintiffs provide no compelling reason to do so and because plaintiffs waited two years to contest the lack of

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[6]For the purposes of this Opinion, board minutes shall include minutes for board committee meetings as well as meetings of the entire Board of Directors.

finalized minutes, even though plaintiffs, defendants contend, knew that finalized minutes were not in existence. Defendants' arguments do not respond to the issues raised by plaintiffs. I conclude from defendants' failure to address Leonard's testimony and plaintiffs' accusations of stonewalling that there may be merit to plaintiffs' contentions.

[13] I originally denied plaintiffs access to the draft minutes because I thought that finalized minutes were adequate. Defendants' failure to turn over final minutes in a timely manner undermine my confidence in that ruling. Moreover, plaintiff show good cause to reconsider this issue, *i.e.*, Leonard's unrebutted testimony that the "finalization" process constituted nothing more than for Leonard to wait for Engle's (possibly self-serving) comments. That process is not the type of legal review for which defendants are entitled to assert attorney-client privilege as a protection against inappropriate discovery. Defendants shall produce all minute drafts as well as Leonard's meeting notes. For the reasons explained in subsection 2 below, this order shall apply to meetings after the filing of plaintiffs' complaints.

2. Post-Complaint Documents

Plaintiffs ask for various materials (Sunstates board & committee meetings, board packages, records of affiliate transactions, and documents relating to management or consulting fees charged to Sunstates by affiliates) created or approved after the filing of their complaints. Defendants object to producing anything created after January 10, 1994, contending that any information created after the filing of the complaints is not relevant to the acts about which plaintiffs complain.[7] Defendants also argue that complying with plaintiffs' request would be overly burdensome and that plaintiffs are using discovery as an offensive weapon. Plaintiffs state that information created after the filing of a complaint can be subject to discovery if the information pertains to the acts described in the complaint or if the complaint alleges misconduct that the defendants are likely to continue after plaintiffs' filings.

[14-15] I conclude that plaintiffs' claim describes a pattern of conduct which, it is reasonable to suppose, defendants may be continuing. Furthermore, I conclude that documents created after the filing of plaintiffs' complaints may describe matters relevant to the events described in the

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[7]Although Rule 26 limits discovery to documents relevant to the subject matter, defendants attempt to transform that limitation to a limit on the time period for which documents may be discovered. They do this by asserting that documents created after the filing of a complaint cannot be relevant to acts that occurred before the filing and that only acts occurring before the filing fall within the subject matter of the complaint.

complaint. Either conclusion provides a basis for me to exercise discretion in allowing discovery past the filing date.[8] The fact that defendants have imposed an information blackout on Sunstates' shareholders by discontinuing Sunstates' public disclosure is critical to my analysis. Discovery is vital in this action, as it is the only means for shareholders to inform themselves of the board's actions. This would not necessarily be the case where a company makes public disclosures on a timely basis. When there is little or no public disclosure, as here, the Court should be less reluctant to give plaintiffs wide latitude in the scope of their discovery. [16] It is reasonable in these circumstances to grant plaintiffs the opportunity to examine recent information pertaining to the continuing wrongs alleged in their complaint. There must be some cut off date for discovery, however, or else defendants would be forced to engage in periodic discovery updates throughout the litigation process. Therefore, I order the time period for discovery to run up until four weeks before the pretrial conference. In the meantime, defendants must turn over all documents (regardless of date of creation) relating to Sunstates board & committee meetings, board packages, records of affiliate transactions, and documents relating to management or consulting fees charged to Sunstates by affiliates.

3. Valuation of Sew Simple

Plaintiffs allege Sunstates committed waste when it acquired Hickory's subsidiary, Sew Simple. Hickory bought Sew Simple for $2 million in 1986 and sold it to Sunstates in 1986 for $17 million. Plaintiffs allege that the Sunstates board knew Sew Simple was not worth the price paid. They seek production of documents created by Sunstates' indirect subsidiary, Alba, to substantiate their assertion. Alba had also considered purchasing Sew Simple at (and after) the time that Sunstates acquired Sew Simple from Hickory. Plaintiffs assert that Alba is wholly-owned by Sunstates (partly through direct holdings and partly through holdings of another Sunstates subsidiary). They allege that Alba rejected the acquisition because a financial analysis of the deal provided to the Alba board by an outside financial advisor showed Sew Simple to be worth less than the price demanded. Plaintiffs seek access to the advisor's valuation of Sew Simple, alleging that Sunstates' top people, who also worked at Alba, knew of the

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[8] *In re Tri-Star Pictures, Inc.*, Del. Ch., C.A. No. 9477, mem. op. at 4, Jacobs, V.C. (Feb. 4, 1991) (allowing discovery of documents dated after the filing of the complaint because they may be relevant to past acts alleged in complaint); *accord Southwest Hide Co. v. Goldston*, 127 F.R.D. 481, 463-84 (N.D. Tex. 1989) (holding that allegations of ongoing wrongful conduct alleged in complaint constitutes reasonable grounds for allowing discovery).

valuation when they approved Sunstates' purchase of Sew Simple. Plaintiffs believe that the valuation will reveal that defendants intentionally overpaid for Sew Simple. Therefore, they request that Alba produce all documents relating to the Alba board's consideration of acquiring Sew Simple; all Alba board meeting packages; and all documents given to Alba by the financial advisor who valued Sew Simple (the valuation materials). Defendants object to production of the valuation materials because the documents are in the possession of Alba, not Sunstates. They also attempt to set an arbitrary cut-off date for production of any documents at April 13, 1992, the day the Sunstates board approved Sew Simple's acquisition. Defendants also object to the discovery of the valuation materials because defendants assert that the request is overly broad and duplicative of requests made to Alba and Sew Simple for the same documents.

Both sides' briefs are unclear as to whether the target of the discovery requests is Alba or Sunstates and the other named defendants; therefore, I assume the motion to be directed to all. Plaintiffs concede, however, that Alba produced all relevant documents in response to plaintiffs' subpoenas. Alba's cooperation moots this motion as to it.

[17] Alba's production also impacts this Court's analysis of what the named defendants must produce. It goes without saying that defendants must respond appropriately to requests for production, but that obligation may be circumscribed where production would be duplicative and, therefore, wasteful or frivolous. I therefore order the named defendants to turn over all valuation materials in their possession not already produced by Alba (or any other party or nonparty).

[18] As to defendants' argument that the discovery should be restricted to before April 13, 1992, I have already explained why this State's liberal discovery rules permit discovery of materials reasonably likely to relate to the subject matter in dispute, even if the materials were created after the filing of the complaint. The same reasoning applies to documents created or acquired by Sunstates after its decision to approve the merger. Though created after the fact, the documents may relate to Sunstates' prior decision to acquire Sew Simple.[9] Therefore, the Court orders Sunstates to turn over all discoverable documents in its possession regardless of when created or when obtained.

4. Payments from Hickory, RDIS, Telco & Other Affiliates to Engle

Plaintiffs ask for all information pertaining to affiliate use of Sunstates' funds. They seek to show that funds siphoned off from Sunstates

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[9] *In re Tri-Star Pictures, Inc., supra* note 8, mem. op. at 4.

were improperly channeled to Engle. Defendants object that the claim is overly broad and not related to Sunstates' alleged wrongdoing.

[19] I cannot agree with defendants' assertion that, even if proved, facts showing funds moved through a series of transactions between affiliates from Sunstates to Engle's back pocket are irrelevant to plaintiffs' claims. These facts, I find, would be highly probative.

Plaintiffs' request asks for documentation of payments to all companies controlled by Engle. The breadth of that request does raise the possibility that those "controlled" companies--which are not defendants in this action--might get unfairly ensnared by this discovery order. Engle, a named defendant, however, can direct compliance from companies that he in fact controls and provide a complete accounting of his (and their) compensation from other affiliates. He can also inform plaintiffs of the timing of any special fees and should be able to trace the ultimate source of payments made to him. If the issue of whether any particular company is controlled by Engle comes into dispute, the Court will address that issue at that time. Otherwise, I direct defendants to produce all records of Sunstates' payments to affiliates and all transfers by affiliates to companies controlled by Engle (or to Engle himself).

5. Sunstates' Bankrupt Subsidiary

Sunstates' insurance subsidiary, Coronet, is in the process of being liquidated by the Illinois Insurance Department. Plaintiffs believe that Coronet's improper investments in affiliates may have drained the company's assets and precipitated its 1996 bankruptcy. They contend that this misconduct is one more instance of Engle looting Sunstates. Plaintiffs seek Coronet's 1995 and 1996 financial statements and documents pertaining to questionable transactions and investments by Coronet that precipitated its receivership with the Illinois Insurance Department.

[20] I can only order discovery of materials relevant to matters raised in the complaint. Coronet is not a defendant, and plaintiffs do not allege that Coronet is an alter ego of Sunstates. Therefore, even though Coronet's financial improprieties may have affected the value of a Sunstates asset, that fact alone does not bring the Coronet problems within the scope of plaintiffs' derivative action against Sunstates. Plaintiffs make allegations that would appear to be proper in a derivative suit brought by Coronet's shareholders on behalf of Coronet, or, if brought by these plaintiffs, in a double derivative suit brought on behalf of Coronet. The alleged wrongdoing is outside the scope of plaintiffs' current complaint, which alleges that defendants looted Sunstates. Therefore, I deny the motions to compel discovery as to Coronet and its activities.

6. Financial Statements for Telco, Hickory, Indiana, RDIS, Coronet & Engle

Plaintiffs ask this Court to compel production of the most recent audited financial statements for Telco, Hickory, RDIS, Indiana, Coronet and Engle. Defendants object that this discovery is not reasonably likely to lead to admissible evidence in this action because the basis of the claim is that Sunstates made wrongful payments, not that the other defendant corporations wrongly used those funds.

[21] First, I deny the request as it pertains to Indiana because Indiana is not named in this action,[10] and plaintiffs have made no showing that Indiana is a wholly-owned subsidiary or alter ego of a named defendant.

[22] Secondly, as to the other corporate defendants, I must reject discovery of their financial statements as overly broad and duplicative. The basis for granting plaintiffs' request as to this matter would be the need to trace defendants' use of Sunstates' funds. That is a legitimate reason to order discovery (as explained in subsection 4 above), but the scope of the information requested by plaintiffs is overly broad. Not every aspect of the corporate defendants' financial picture is related to the claims of Sunstates' shareholders. To give the shareholders access to such a wide range of information would expand the litigation into the other corporate defendants' financial situation. That information is not relevant to the issues arising in this suit and need not be produced.[11]

In rejecting this request, I am reassured that my decision is not overly restrictive because I granted plaintiffs' request (in subsection 4) for all documents pertaining to money flows from Sunstates to Engle through the web of affiliates. The scope of that request is reasonable in light of this action's subject matter (the alleged looting of Sunstates). Moreover, insofar as this request is relevant to plaintiffs' consolidated action, it is duplicative of subsection 4's request for information pertaining to money flows. And, to the extent that this request is not duplicative, it does not pertain to Sunstates' money flows and is irrelevant to this action. Therefore, I deny the request for financial statements of the defendant corporations. Engle's personal financial statements will be produced in redacted form, subject, if

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[10]Plaintiffs' Opening Brief does not list Indiana as a named defendant in the "Nature and Stage of the Proceedings." Exhibit "A" to Plaintiffs' Reply Brief lists Indiana Financial Investors, Inc., as a 24.6% owner of Sunstates and 50% owned by Hickory. For the purposes of this motion, plaintiffs have failed to show that Indiana is controlled by a defendant over whom I have personal jurisdiction.

[11]In other words, audited statements must be produced beginning with the quarter after the last 10-k until the most recent available statement. Defendants must also produce unaudited statements for any quarter for which an audited statement is unavailable, including the most recent unaudited statements.

demanded, to *in camera* inspection, to the extent they reflect income received from defendant Sunstates or its affiliates.

7. Corporate Fact Book

Sunstates maintains a corporate fact book that contains a list of employees with knowledge of issues raised in this litigation. Plaintiffs seek access to this book to identify people whom they may wish to depose. Defendants contend that the request is late and overly broad (because the book also contains unrelated materials) and, moreover, that the book was created after the filing of this litigation.

[23] Turning over this book is a simple affair. The book contains information reasonably related to this litigation. I have already rejected defendants' arguments for limiting discovery to before the filing date of the complaint. If the book contains material that is clearly unrelated to these proceedings, the production of which would disclose confidential business information, defendants may prepare a "privilege log," produce what is relevant, and inform plaintiffs of the nature of the log's entries. I order Sunstates to make the book otherwise available to plaintiffs.

8. Defendants' General Objections

[24] This motion contained a section in which plaintiffs asked for orders to compel production for particular discovery requests (dealt with above) and a section criticizing defendants' general objections to past discovery. The latter section asked the Court to order defendants to provide details as to what documents had not been produced under defendants' general objections. Defendants generally objected to requests for documents because the requests were (1) not relevant; (2) overly burdensome; or (3) in the possession of non-defendant affiliates. Plaintiffs demand that defendants specifically describe the documents withheld on these grounds, but defendants have mooted the issue by stating in the answering brief that plaintiffs were refused no documents solely on the grounds of relevancy or burden. The earlier portions of this opinion dealt with all discovery objections based on defendants' lack of control over affiliates. Thus, the general objections are, for all purposes, mooted by defendants' Answering Brief and earlier parts of this Opinion.

II. Conclusion

In evaluating plaintiffs' requests, I have kept in mind the liberal nature of this Court's discovery rules and the fact that the "scope of inquiry for

purposes of discovery is broader than the test for admissibility at trial."[12] At the same time, I have tried to strike a balance by ordering only discovery relevant to the claims alleged in the complaint. I hereby order the parties to comply with the discovery requests granted above. Plaintiffs' motion is ***granted in part; denied in part.***

IT IS SO ORDERED.

IN RE FREDERICK'S OF HOLLYWOOD, INC. SHAREHOLDERS LITIGATION

No. 15,944 (Consolidated)

Court of Chancery of the State of Delaware, New Castle

July 9, 1998

Plaintiff shareholders served and filed an amended class action complaint against the individual board of directors of defendant company alleging that they breached their fiduciary duties to the class, and the defendants which are a family of companies that acquired defendant company. Defendants are charged with having aided and abetted a breach of a fiduciary duty, and for having tortiously interfered with the plaintiff shareholders' opportunity to obtain a higher price for their stocks from a competing bidder.

The court of chancery, per Vice-Chancellor Jacobs, concluded that even if it is assumed that arm's-length negotiations, or its absence, is not a decisive factor, the plaintiffs have failed to state a cognizable claim for aiding and abetting. None of the plaintiffs' cited authorities supports their position. In addition, the court concluded that the plaintiffs have failed to state a claim for tortious interference with prospective business relations.

1. Pretrial Procedure ⇐ 3

A motion to dismiss under Rule 12(b)(6) will be granted whenever it appears with reasonable certainty that under any set of facts which could be

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[12]*Southwest Hide Co.*, 127 F.R.D. at 483.

proven to support the claim, plaintiff would not be entitled to relief. DEL. CH. CT. R. 12(b)(6).

2. Pretrial Procedure 3

In deciding a motion to dismiss under Rule 12(b)(6), the court accepts the well-pleaded allegations of the complaint as true, and draws all reasonable inferences from them, but it does not accept conclusory statements made without specific, supportive allegations of fact. DEL. CH. CT. R. 12(b)(6).

3. Conspiracy 2

A cognizable claim for aiding and abetting requires plaintiffs to establish: the existence of a fiduciary relationship, breach of fiduciary's duty, and knowing participation in that breach by defendants who are not fiduciaries.

4. Conspiracy 2

Plaintiffs fail to state a cognizable claim for aiding and abetting where nothing in the complaint suggests complicity between a corporation's board and a nonfiduciary purchaser of the corporation.

5. Conspiracy 2

An offeror who conducts arm's-length negotiations leading to an acquisition agreement cannot be said to be knowingly participating in an alleged breach of fiduciary duty by the target board.

6. Torts 12

The elements of tortious interference with prospective contractual relations are: the existence of a valid business relation or expectancy, the interferer's knowledge of the relationship or expectancy, intentional interference that induces or causes a breach or termination of the relationship or expectancy, and that causes resulting damages to the party whose relationship or expectancy is disrupted.

7. Torts ⇐ 12, 239

Plaintiffs failed to state a claim for tortious interference with prospective business relations where, although plaintiffs argued that the board had power to issue a dilutive option, they did not allege that the board had a fiduciary or other duty to exercise that power.

8. Corporations ⇐ 310(1)

Except where the majority stockholder is acting to maintain corporate control or is threatening to exploit the vulnerability of the minority stockholders, the issuance of a dilutive option would constitute a breach of fiduciary duty in violation of Delaware law.

9. Corporations ⇐ 310(1)

Plaintiffs have not pled that a valid business expectancy existed, because the complaint reveals no lawful way that defendant could have circumvented the majority shareholder's right to vote down any transaction it did not favor.

10. Corporations ⇐ 310(1)

Plaintiff shareholders failed to adequately allege that defendants wrongfully induced or caused the board to breach its fiduciary duties to the shareholders by rejecting a higher offer and accepting a lower one; since they only became majority shareholders after they had entered into the merger agreement and sought to protect its contract rights against its competitors for corporate control, defendants cannot be said to have wrongfully interfered with a contract right or expectancy belonging to the plaintiff shareholders.

Norman M. Monhait, Esquire, of Rosenthal, Monhait, Gross & Goddess, P.A., Wilmington, Delaware; Goodkind, Labaton, Rudoff & Sucharow LLP, New York, New York, of counsel; Law Offices of Jeffrey S. Abraham, New York, New York, of counsel; Lowey, Dannenberg, Bemporad & Selinger, P.C., White Plains, New York, of counsel; Hanzman, Criden, Korge, Chaykin, Ponce & Heise, P.A., Miami, Florida, of counsel; Schubert & Reed, LLP, San Francisco, California, of counsel; and Cohn, Lifland, Pearlman, Herrmann & Knopk, Saddle Brook, New Jersey, of counsel, for plaintiffs.

William D. Johnston, Esquire, and John W. Shaw, Esquire, of Young, Conaway, Stargatt & Taylor, LLP, Wilmington, Delaware; and Suzanne L. Saxman, Esquire, and Peter Petrakis, Esquire, of D'Ancona & Pflaum, Chicago, Illinois, of counsel, for defendants Royalty Acquisition Corporation, Royalty Corporation, Knightsbridge Capital Corporation, and Frederick's of Hollywood, Inc.

A. Gilchrist Sparks, III, Esquire, William M. Lafferty, Esquire, and Jon E. Abramczyk, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware, for defendants George W. Townson, Richard O. Starbird, William J. Barrett, and Merle A. Johnston.

Stephen E. Jenkins, Esquire, of Ashby & Geddes, Wilmington, Delaware, for defendant Hugh V. Hunter.

JACOBS, *Vice-Chancellor*

Pending is a motion by the defendants Royalty Acquisition Corp., Royalty Corporation, and Knightsbridge Capital Corporation ("Knightsbridge" or the "Knightsbridge defendants")[1] to dismiss the complaint under Court of Chancery Rule 12(b)(6) for failure to state a claim upon which relief can be granted. On October 29, 1997, the plaintiffs, who are shareholders of Frederick's of Hollywood ("Frederick's"), served and filed an amended class action complaint against (i) the individual directors of Frederick's (the "Frederick's defendants") alleging that they breached their fiduciary duties to the class, and (ii) the Knightsbridge defendants, which are a family of companies that acquired Frederick's in late 1997. The Knightsbridge defendants are charged with having "aided and abetted" the individual director defendants' breach of their fiduciary duties, and for having "tortiously interfered" with the Frederick's shareholders' opportunity to obtain a higher price (from a competing bidder) for their stock. For the reasons that follow, the Knightsbridge defendants' motion to dismiss will be granted.

I. FACTS

On June 14, 1996 Frederick's, a Delaware corporation and retailer of women's lingerie and apparel, announced that it had retained Janney

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[1]Royalty Acquisition Corp. is a Delaware corporation and a wholly owned subsidiary of Royalty Corporation, also a Delaware corporation and a wholly owned subsidiary of Knightsbridge Capital Corporation ("Knightsbridge").

Montgomery Scott Inc., an investment bank, for the purpose of enhancing shareholder value. During the next fifteen months, Janney Montgomery Scott, Inc. conferred with over one hundred prospective purchasers of Frederick's. It received indications of interest from twelve, of which nine, including Knightsbridge Capital Corporation ("Knightsbridge"), conducted additional due diligence. Ultimately, the board found the Knightsbridge proposal the most favorable. On June 15, 1997 Knightsbridge and Frederick's executed a merger agreement under which Knightsbridge would purchase all of Frederick's outstanding shares for $6.14 cash per share.

On August 6, 1997, Frederick's commenced a consent solicitation seeking its shareholders' approval of the proposed merger with Knightsbridge. Certain trusts that owned 43.4% of Frederick's Class A stock, and 53.5% of Frederick's Class B stock,[2] publicly announced their consent to the proposed merger.

On August 21, 1997, the Milton Partners made an unsolicited offer to purchase Frederick's stock for $7.00 per share cash. In response, on August 23, 1997, Knightsbridge and the Trusts entered into a stock purchase agreement whereby Knightsbridge agreed to purchase the Trusts' stock interest in Frederick's for $6.90 per share, and to pay that same price in the merger for the shares held by Frederick's remaining stockholders. The stock purchase agreement was made subject to certain conditions, one of which was that Frederick's not terminate the merger agreement with Knightsbridge in favor of another bidder's offer.

On August 27, 1997 The Veritas Capital Fund, L.P. ("Veritas") made an unsolicited "nonbinding" offer to purchase all of Frederick's stock for $7.75 per share cash.[3] Veritas emphasized that its "offer" was not binding, which essentially meant that Veritas was inviting Frederick's to make an offer, which Veritas would then determine whether or not to accept. In response, on August 28, 1997, the Frederick's board postponed the scheduled closing of the merger with Knightsbridge in order to evaluate the Veritas proposal. Later that same day, Knightsbridge sent letters to Veritas and Frederick's, informing both that Knightsbridge had acquired the almost-majority stock interest held by the Trusts, and that Knightsbridge intended to vote those shares against any acquisition proposal except its own.

Despite Knightsbridge's opposition, the Frederick's board of directors sent a letter to Veritas, requesting Veritas to deliver to Frederick's (i) $2.5 million, to be deposited in escrow, and (ii) a merger agreement in substantially the same form as the Knightsbridge merger agreement. In

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[2]Specifically, the Frederick N. Mellinger Trust and the Harriet R. Mellinger Trust. There is no material difference between the Class A and the Class B stock for the purposes of this dispute.

[3]The board of Frederick's rejected the offer by the Milton Partners, which dropped out of the bidding contest after Veritas and Knightsbridge made higher offers.

response, Veritas sent a letter to the Frederick's board, requesting that it issue to Veritas a "dilutive option" to purchase newly issued shares of Frederick's in an amount sufficient to dilute Knightsbridge's significant stock interest. Veritas also submitted to Frederick's a marked up merger agreement, as well as the requested $2.5 million escrow deposit.

In response to the Veritas $7.75 per share cash proposal, Knightsbridge increased its offer to $7.75 per share cash, subject, however, to certain conditions. Veritas' conditions were that (i) Frederick's enter into an agreement whereby it would cease all current negotiations with all other bidders, (ii) Frederick's agree to remove the "fiduciary out" provision of the original Knightsbridge merger agreement that permitted Frederick's to negotiate with other prospective bidders if necessary to discharge the board's fiduciary duties, (iii) the Frederick's board, if it were to issue an option or enter into an agreement with any third party, would enter into (or issue) an identical agreement with (or identical option to) Knightsbridge, (iv) the termination fee payable to Knightsbridge if Frederick's were sold to another bidder would be increased from $1.8 million to $4.5 million, and (v) Knightsbridge would have the right to appoint an observer to attend Frederick's future board meetings.

On September 9, 1997, the Knightsbridge defendants purchased an additional 195,000 shares of Frederick's Class A stock on the open market. That purchase increased Knightsbridge's interest to an absolute majority of both classes of Frederick's stock. Undaunted by this development, Veritas responded on September 11, 1997 with an unsolicited $9.00 per share "non-binding offer" for Frederick's shares. The Frederick's board, however, did not respond to Veritas' latest proposal but, rather, committed the company to Knightsbridge's $7.75 per share proposal.

On September 29, 1997, after briefing and argument, this Court denied the plaintiffs' motion to enjoin the merger between Knightsbridge and Frederick's. Soon thereafter the merger closed, and this action went forward as a suit for damages. The Knightsbridge defendants next brought on the pending motion to dismiss.

II. CONTENTIONS AND ANALYSIS

[1-2] A motion to dismiss under Rule 12(b)(6) will be granted whenever "it appears with reasonable certainty that under any set of facts which could be proven to support the claim, plaintiff would not be entitled to relief."[4] In deciding a motion to dismiss under Rule 12(b)(6), the Court accepts the well-pleaded allegations of the complaint as true, and draws all reasonable

[4]In re Santa Fe Pac. Corp. Shareholder Litig., Del. Supr., 669 A.2d 59, 65 (1995).

inferences from them, but it does not accept conclusory statements made without specific, supportive allegations of fact.[5]

This standard, as applied to the instant complaint, gives rise to two issues: (i) does the amended complaint state a valid claim for aiding and abetting a breach of a fiduciary duty, and (ii) does the amended complaint state a valid claim of tortious interference with prospective contractual relations? Those issues are now addressed.

1. Aiding and Abetting

[3] To state a cognizable claim for aiding and abetting, the plaintiffs must establish "(1) the existence of a fiduciary relationship, (2) the breach of the fiduciary's duty and (3) a knowing participation in that breach by the defendants who are not fiduciaries."[6]

The defendants argue that the complaint fails to state a cognizable aiding and abetting claim, because the plaintiffs (i) have not alleged a predicate breach of fiduciary duty, and (ii) have not alleged facts that would establish actual knowledge of and participation by Knightsbridge in any breach of fiduciary duty by the Frederick's board.[7] In that connection, the Knightsbridge defendants argue that the complaint must (but did not) allege that the negotiations leading to the merger agreement were not at arm's-length. The reason, it is argued, is that arm's-length negotiations operate to negate any claim that Knightsbridge knowingly participated in a breach of fiduciary duty by the parties with whom Knightsbridge was negotiating.[8] Here, the defendants urge, the aiding and abetting claim must be dismissed because the complaint plainly alleges that the negotiations were at arm's-length.

The plaintiffs disagree. They insist that they have properly pleaded every element of a claim of aiding and abetting a breach of fiduciary duty. Specifically, they contend that the complaint alleges that the Frederick's director defendants breached their fiduciary duties by (i) failing to

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[5]Solomon v. Pathe Communications Corp., Del. Supr., 672 A.2d 35, 38 (1996).

[6]Weinberger v. Rio Grande Indus., Inc., Del. Ch., 519 A.2d 116, 131 (1986).

[7]Greenfield v. Tele-Communications, Inc., Del. Ch., C.A. No. 9814, Allen, C. (May 10, 1989); see, e.g., Associated Imports, Inc. v. ASG Industries, Inc., Del. Ch., C.A. No. 5953, Duffy, J. (June 20, 1984).

[8]This Court has consistently held that evidence of arm's-length negotiation with fiduciaries negates a claim of aiding and abetting, because such evidence precludes a showing that the defendants knowingly participated in the breach by the fiduciaries. Greenfield v. Tele-Communications, Inc., Del. Ch., C.A. No. 9814, Allen, C. (May 10, 1989); Repairman's Service Corp. v. National Intergroup, Inc., Del. Ch., C.A. No. 7811, Walsh, V.C. (Mar. 15, 1985) (aiding and abetting claim dismissed on the basis that "there was intensive arm's-length bargaining between the parties with demands made and concessions granted on both sides.").

adequately inform themselves about the terms of the Veritas proposal, (ii) failing to enact corporate measures to secure the best value for their shareholders (such as issuing a dilutive option to Veritas),[9] (iii) unduly favoring Knightsbridge over Veritas, and (iv) securing personal benefits for themselves in the Frederick's-Knightsbridge transaction.

In addition, the plaintiffs argue that the element of "knowing participation" by Knightsbridge in the Frederick's directors' alleged breach of duty is inferable from the pleaded facts that Knightsbridge: (i) mischaracterized as "ownership"[10] the interest of its affiliate, Royalty Corporation, in the Frederick's stock held by the Trusts, (ii) threatened to sue if Frederick's accepted another offer, (iii) attempted to close the merger earlier than originally planned to preclude the Frederick's director defendants from fully exploring Veritas' "offer," and (iv) attempting to block Veritas from acquiring Frederick's by conditioning their own offer upon the inclusion of a "no-talk" provision that would require Frederick's to terminate its discussions with Veritas. Finally, the plaintiffs contend that allegations of arm's-length negotiation cannot, alone and without more, defeat a claim of aiding and abetting. Stated differently, the plaintiffs do not dispute that arm's-length negotiations took place, but contend that even if the negotiations were at arm's-length, a claim for aiding and abetting would still lie.

[4] The Court concludes that even if it is assumed arguendo that arm's-length negotiation (or its absence) is not a decisive factor, the plaintiffs have failed to state a cognizable claim for aiding and abetting. Nothing in the complaint suggests complicity of any kind between Knightsbridge and the Frederick's board, let alone "knowing participation" by Knightsbridge in a breach of fiduciary duty by that board. That, plus the pleaded fact that the agreements reached were the product of arm's-length negotiations,[11] confirms the insufficiency of the complaint as a matter of law.

[5] None of the plaintiffs' cited authorities supports their position.[12] Gilbert v. El Paso was a class action brought against a tender offeror-acquiror and the target company by target company shareholders who had

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[9]That, however, would appear to be contrary to Delaware law. See Mendel v. Carroll, Del. Ch., 651 A.2d 297 (1994).

[10]Royalty Corporation's interest in the shares held by the Trusts was subject to the condition that Frederick's not terminate the merger agreement with Knightsbridge in favor of a better offer. Because of that condition, the plaintiffs argue that Royalty Corporation's interest could not be reasonably characterized as "ownership."

[11]Knightsbridge's initial offer was for $6.14, even though there was a binding merger agreement in place, Knightsbridge later increased its offer to $6.90, and later to $7.75.

[12]The plaintiffs cite three cases that, they claim, support their position: Gilbert v. El Paso, Del. Ch., 490 A.2d 1050 (1984), Zirn v. VLI Corp., Del. Ch., C.A. No. 9488, Hartnett, V.C. (July 17, 1989) and Penn Mart Realty Co. v. Becker, Del. Ch., 298 A.2d 349 (1972).

tendered their stock into the first offer, which the offeror later terminated. The gravamen of the complaint was that the shareholder class was wrongfully subjected to proration in the new, revised offer, because the first offer was terminated by reason of a conspiracy between the acquiror and the target company board, that amounted to the acquiror aiding and abetting the target company board's breach of fiduciary duty. This Court held that the offeror did not, in that capacity, owe fiduciary duties to the target's shareholders, and that the offeror's exercise of a reserved contract right to terminate or amend its offer did not violate any contract rights of the shareholder class. In reaching that result, the Court stated that "an offeror who does participate in a target board's breach of fiduciary duty, cannot be said to be conducting arm's-length negotiations."[13] By reverse implication, an offeror who conducts arm's-length negotiations leading to an acquisition agreement cannot be said to be knowingly participating in an alleged breach of fiduciary duty by the target board. In this case, the complaint alleges that Knightsbridge and the Frederick's board negotiated their agreement at arm's-length.[14]

Tomczak v. Morton Thiokol, Inc.[15] is far more apposite. There, certain shareholders of Morton Thiokol challenged the sale of a key division of Morton Thiokol to Dow Chemical Company ("Dow"). The plaintiffs alleged that the Morton Thiokol directors' approval of the sale constituted a breach of their fiduciary duties, which Dow had aided and abetted. This Court held that Dow, the acquiror, had done nothing that constituted actionable aiding and abetting, and observed that:

> Although Dow's purchases certainly had the effect of putting economic pressure on Morton Thiokol, what Dow essentially did was to simply pursue arm's-length negotiations with

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[13]Gilbert, 490 A.2d at 1058.

[14]The plaintiffs' reliance on Zirn and Penn Mart is similarly misplaced. In Zirn, this Court denied a motion to dismiss a complaint that charged a third party acquiror with aiding and abetting. The Court held that it could be inferred from the complaint ("if only barely so") that the third party-offeror knew that the director defendants had a conflict of interest created by their potential liability to the company's shareholders if a certain patent was not reinstated; and that the offeror may have used that knowledge to its advantage in negotiating a revised merger agreement. Here, no conflict of interest is alleged. In Penn Mart, this Court held that a complaint that charged a purchaser of stock who acquired the stock with the benefit of inside information about the true worth of the corporation's assets and knew that it was dealing with fiduciaries, stated a claim for aiding and abetting the corporation's directors in a breach of fiduciary duties, in agreeing to sell the stock to the buyer for less than fair value. The complaint here contains no allegation of improper use of insider information about the value of Frederick's stock or assets.

[15]Del. Ch., C.A. No. 761, Hartnett, V.C. (April 5, 1990).

> Morton Thiokol through their respective investment bankers in an effort to obtain Texize at the best price that it could.[16]

Essentially, that is all the complaint alleges that Knightsbridge did here. Accordingly, the claim of aiding and abetting is insufficient as a matter of law.

2. Tortious Interference with Prospective Contractual Relations

[6] The second issue is whether the plaintiffs have stated a cognizable claim of interference with prospective contractual relations. The elements of that tort are:

> (1) the existence of a valid business relation or expectancy, (2) the interferer's knowledge of the relationship or expectancy, (3) intentional interference that (4) induces or causes a breach or termination of the relationship or expectancy and that (5) causes resulting damages to the party whose relationship or expectancy is disrupted.[17]

Of these elements, three are not seriously contested, namely, the interferer's knowledge of the relationship or expectancy, that the interferer caused a breach of the relationship or expectancy, and that the interferer caused resulting damages. The issues, therefore, become whether the plaintiffs had a valid business relation or expectancy with Veritas, and if so, whether Knightsbridge intentionally and wrongfully interfered with it.

The essence of the claim is that Knightsbridge intentionally and tortiously interfered with Frederick's shareholders' expectancy of obtaining a higher price for their stock, namely, Veritas' $9.00 per share proposal. The Knightsbridge defendants argue that no valid claim is stated because Veritas never tendered a definitive merger agreement to the board of Frederick's. Therefore, Veritas' $9.00 per share offer was not "real" and cannot be considered as bona fide for purposes of this analysis. Alternatively, the Knightsbridge defendants argue that even if the Veritas offer was "real," Knightsbridge, as Frederick's majority stockholder, was legally entitled to -- and stated that it would -- vote its stock against any offer by Veritas. That being the case, the defendants argue that no "valid" business expectancy existed or could arise as a matter of law.

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[16] Id. at 40-41.

[17] CPM Indus., Inc. v. Fayda Chemicals & Minerals, Inc., Del. Ch., C.A. No. 15996, Jacobs, V.C. (Nov. 26, 1997), and cases cited therein.

Alternatively, the Knightsbridge defendants contend that even if a valid business expectancy did arise, the Knightsbridge defendants did not wrongfully interfere with it, because Knightsbridge, in its capacity as Frederick's majority shareholder, had no duty to vote for a transaction that it opposed.

The plaintiffs disagree. They respond that because the Frederick's board could have issued a dilutive option that would have reduced Knightsbridge's stock interest below 51% to facilitate a transaction with Veritas, the Frederick's shareholders did have a reasonable expectancy of a business relationship. The plaintiffs further argue that because the merger with Knightsbridge closed at $7.75 per share despite Veritas' outstanding $9.00 per share offer, the shareholder class suffered damages of at least $1.25 per share. The plaintiffs contend that the existence of a valid business expectancy is further supported by paragraph 16 of their complaint, which alleges that Knightsbridge would receive a $1.8 million break-up fee if the Frederick's board accepted a different proposal. That break-up fee provision, plaintiffs say, establishes that the Frederick's directors themselves implicitly acknowledged that Frederick's shareholders could reasonably expect to reap the benefit of a superior offer, if one became available.

[7-9] Having considered these conflicting arguments, the Court concludes that the plaintiffs have failed to state a claim for tortious interference with prospective business relations. Although the plaintiffs argue that Frederick's board had the power to issue a dilutive option, they do not allege that the board had a fiduciary or other duty to exercise that power. Moreover, the limited case law on this subject indicates that except where the majority stockholder is acting to maintain corporate control or is threatening to exploit the vulnerability of the minority stockholders, the issuance of a "dilutive option" would constitute a breach of fiduciary duty in violation of Delaware law.[18] In short, the plaintiffs have not pled that a valid business expectancy existed, because the complaint reveals no lawful way that Frederick's could have circumvented Knightsbridge's power (and, as the majority shareholder, its right) to vote down any transaction it did not favor.[19]

[10] Finally, the complaint fails adequately to allege that the Knightsbridge defendants wrongfully induced or caused the board of Frederick's to breach its fiduciary duties to the shareholders by rejecting Veritas' higher offer and

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[18]See Mendel v. Carroll, n.9, supra.

[19]Nor have the plaintiffs alleged facts establishing that Knightsbridge's exercise of that voting power would be wrongful. Under Delaware Law, a majority shareholder is not obligated to vote its shares in favor of a transaction that it opposes. See Emerson Radio Corp. v. International Jensen Inc., Del. Ch., C.A. Nos. 15130 & 14992, Jacobs, V.C. (1996); Thorpe v. Cerbco, Inc., Del. Supr., 676 A.2d 436, 444 (1996); Bershad v. Curtiss-Wright Corp., Del. Supr., 535 A.2d 840, 845 (1987).

accepting Knightsbridge's lower one. Although the plaintiffs make much of the fact that Knightsbridge became a majority shareholder of Frederick's, that fact, without more, does not end the analysis, because Knightsbridge did not become a majority shareholder until after it had entered into a merger agreement with Frederick's. By seeking thereafter to protect its contract rights against its competitors for corporate control, Knightsbridge cannot be said to have wrongfully interfered with a contract right or expectancy belonging to Frederick's shareholders.

For these reasons, the complaint must be dismissed for failure to state a claim for tortious interference with prospective business relations.

III. CONCLUSION

The Knightsbridge defendants' motion to dismiss the plaintiffs' claims for aiding and abetting a breach of a fiduciary duty and for tortious interference with prospective business relations is hereby granted. The parties shall confer and submit an appropriate form of order.

HARBOR FINANCE PARTNERS LTD. v. BUTLER

No. 16,334

ELLIOTT ASSOCIATES, L.P. v. AVATEX CORP.

No. 16,336

Court of Chancery of the State of Delaware, New Castle

June 3, 1998

Plaintiffs, preferred shareholders in defendnat corporation, brought an action challenging the absence of a requirement for a preferred stock class vote on a merger agreement wherein the outstanding preferred stock would be converted into the right to receive shares of common stock in the surviving corporation. Plaintiffs based this claim on provisions of the restated certificate of incorporation and certificate of designation which provided the right to a series vote of preferred stock in the event of an

amendment, alteration, or repeal, whether by merger, consolidation, or otherwise, of any provision of the certificates which would materially and adversely affect the preferred stock or its holders. Defendants filed a motion for judgment on the pleadings with respect to this claim.

The court of chancery, per Vice-Chancellor Lamb, held that the provisions governing the preferred stock held by plaintiffs provided no right to a preferred stock class vote upon the proposed merger. The court concluded that the materially adverse affect confronting the preferred stockholders flowed from the threatened conversion of their shares into common stock of the surviving corporation and not from any amendment, alteration, or repeal of the certificate of designation; and the presence of an express provision in a certificate of designation of one series of preferred stock providing for a right to a class vote in certain mergers was strong evidence that no other class voting rights in the case of mergers should be inferred or implied. Accordingly, the court granted defendants' motion for judgment on the pleadings with respect to plaintiffs' claim of entitlement to a preferred stock class vote.

1. Pleading ⇐ 342, 343

A motion for judgment on the pleadings may be granted only when no material issue of fact exists and the movant is entitled to judgment as a matter of law. DEL. CH. CT. R. 12(c).

2. Pleading ⇐ 343, 350(1), 350(7)

In deciding a motion for judgment on the pleadings, the court is required to view the facts pleaded and the inferences to be drawn from such facts in a light most favorable to the nonmoving party. DEL. CH. CT. R. 12(c).

3. Corporations ⇐ 197
Pleading ⇐ 342

Whether preferred stockholders are entitled to a class vote on a proposed merger under the certificates governing the rights of the preferred stockholders is an issue of law which can be decided on a motion for judgment on the pleadings.

4. Corporations ⇐ 197, 582, 583

There is no requirement in the Delaware General Corporation Law or at common law that preferred shares receive a class or series vote in connection with a merger; to adopt an agreement of merger, the Delaware General Corporation Law requires only the affirmative vote of a majority of the outstanding stock of the corporation entitled to vote thereon. DEL. CODE ANN. tit. 8, § 251 (1998).

5. Corporations ⇐ 62, 197

The Delaware General Corporation Law permits the creation of classes or series of stock having such voting powers, full or limited, or no voting powers as shall be stated and expressed in the corporate charter or a certificate of designation. DEL. CODE ANN. tit. 8, § 151(a) (1998).

6. Corporations ⇐ 156, 197

The voting rights defined by the charter and certificates of designation indicating preferred stock had no voting rights were unquestionably contractual in nature.

7. Contracts ⇐ 153
Corporations ⇐ 154, 156

The meaning of provisions of a charter and certificates of designation will be interpreted using standard rules of contract interpretation, which require a court to determine, from the language of the contract, the intent of the parties.

8. Contracts ⇐ 153
Corporations ⇐ 154, 156

In discerning the intent of the parties under rules of contract interpretation, the certificate should be read as a whole and, if possible, interpreted to reconcile all of the provisions of the document.

9. Corporations ⇐ 62, 156

It is clearly established under Delaware law that the special contractual rights or preferences of preferred stock must be strictly construed.

10. Corporations ⇐ 154, 156

At common law and in the absence of an agreement to the contrary, all shares of stock are equal; unless preferences are expressed in clear language, they shall not exist.

11. Corporations ⇐ 154, 156

Nothing is to be presumed in favor of preferences attached to stock, but rather, preferences must be expressed in clear language.

12. Corporations ⇐ 154, 156, 197

Under Delaware law, it is clearly established that class voting rights are special rights and are to be narrowly construed.

13. Corporations ⇐ 62, 154, 156, 197

Class voting rights, where they exist, are in derogation of the common law principal, and the general provision of section 212 of the Delaware General Corporation Law, that all shares vote equally. DEL. CODE ANN. tit. 8, § 212 (1998).

14. Corporations ⇐ 62, 582

Delaware law permits the conversion of securities, by merger, into shares or other securities of the corporation surviving or resulting from a merger or consolidation, or into cash, property, rights or securities of any other corporation. DEL. CODE ANN. tit. 8, § 251(b) (1998).

15. Contracts ⇐ 159
Corporations ⇐ 583, 584

Provision in preferred stock certificate of designation, which requires class vote whenever an amendment, alteration, or repeal, whether by merger, consolidation, or otherwise, of any provisions of the certificates of incorporation or designation would materially and adversely affect the preferred stock or its holders, does not allow for a class vote on a proposed merger; the language "whether by merger, amendment, or otherwise" only modifies the phrase "amendment, alteration or repeal" and does not independently create a right to a class vote in the case of every merger.

16. Corporations ⇐ 583, 584

Materially adverse affect confronting preferred stockholders flowed from the threatened conversion of their shares into common stock of the surviving corporation and not from any amendment, alteration, or repeal of the certificate of designation; it is only a matter of housekeeping detail whether the charter of the surviving corporation has certificate provisions identical to those governing the preferred shares, since, by operation of the proposed merger, there will be no such preferred shares outstanding to be affected by any such provisions. DEL. CODE ANN. tit. 8, § 243 (1998).

17. Contracts ⇐ 151, 153
Corporations ⇐ 583, 584

Certificates of incorporation are to be read as a whole in order to determine the meaning intended to be given any portion of them.

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Kevin G. Abrams, Esquire, Thomas A. Beck, Esquire, Holly June Steifel, Esquire, and Thad J. Bracegirdle, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and Weil, Gotshal & Manges, LLP, of New York, New York, of counsel, for defendants.

LAMB, *Vice-Chancellor*

I. INTRODUCTION

These consolidated cases arise out of the action taken by the board of directors of defendant Avatex Corporation ("Avatex"), announced on April 14, 1998, to approve a proposal to merge Avatex with and into Xetava Corporation ("Xetava"), a wholly owned subsidiary of Avatex formed solely for that purpose ("the Proposed Merger"). If the common stockholders vote

to approve the Proposed Merger and it is consummated, Avatex's outstanding preferred stock will be converted into the right to receive shares of common stock in the surviving corporation aggregating approximately seventy-three percent (73%) of the total. Holders of Avatex common stock will receive the remaining equity.

Holders of shares of the two outstanding series of Avatex preferred stock began these actions shortly after the April 14 announcement, thereby challenging both the fairness of the terms of the Proposed Merger and the absence of a requirement for a preferred stock class vote in the merger agreement. Defendants have moved for judgment on the pleadings with respect to Counts II, III and IV of the complaint filed in C.A. No. 16334 (the "Harbor Finance Complaint") and Count I of the complaint filed in C.A. No. 16336 (the "Elliot Associates Complaint"), which allege the existence of an entitlement to a class vote. For the reasons discussed below, I conclude that there is no right to a class vote in the circumstances presented and grant the motion.

II. BACKGROUND

A. The Parties

Defendant Avatex is a Delaware corporation having its principal place of business in Dallas, Texas. Avatex is a holding company that, along with its subsidiaries, owns interests in other corporations and partnerships. Currently, Avatex has authorized three series of preferred stock: (i) $5.00 Cumulative Convertible Preferred Stock (the "First Series Preferred Stock"), of which there are 652,331 outstanding shares; (ii) $3.56 Cumulative Preferred Stock (the "Second Series Preferred Stock"), of which there are no outstanding shares; and (iii) $4.20 Cumulative Exchangeable Series A Preferred Stock (the "Series A Preferred Stock"), of which there are 4,312,351 outstanding shares. In addition, Avatex has 13,806,375 shares of outstanding common stock. Defendant Xetava is a Delaware corporation and a wholly-owned subsidiary of Avatex.

Defendants Abbey J. Butler ("Butler") and Melvyn J. Estrin ("Estrin") have been directors of Avatex since 1990. Butler and Estrin also have served as co-chairmen of the Avatex Board and co-chief executive officers of Avatex since 1991. Defendants Hyman H. Frankel, Fred S. Katz, Charles C. Pecarro, William A. Lemer and John L. Wineapple have been directors of Avatex since February 1997.

Plaintiffs Harbor Finance Partners, Ltd. ("Harbor"), Anvil Investment Partners, L.P. ("Anvil") and Elliott Associates, L.P. ("Elliott") purport to be the record and/or beneficial owners of the First Series Preferred Stock and/or

the Series A Preferred Stock. Harbor and Anvil have brought their action as a class action on behalf of all holders of First Series Preferred Stock and Series A Preferred Stock.

B. The Voting Rights Of The Avatex Preferred Stock

On March 18, 1983, Avatex filed the Restated Certificate with the Delaware Secretary of State. Article Fourth of the Restated Certificate authorizes "blank check" preferred stock. With respect to the voting rights afforded the Avatex preferred stock, Article Fourth, Section 7 of the Restated Certificate provides that "[e]xcept as otherwise specifically provided in this Article or as may be fixed by the Board of Directors as hereinbefore provided, or as otherwise expressly required by law, the holders of preferred stock shall not have any right to vote for the election of directors or for any other purpose. . . ." Section 4 of Article Fourth provides the following voting rights to holders of Avatex preferred stock:

> So long as any of the preferred stock remains outstanding, the consent of the holders of at least a majority of all outstanding shares of preferred stock regardless of series . . . shall be necessary for effecting or validating any amendment, alteration or repeal of any of the provisions of this Article (including any resolutions adopted by the Board of Directors pursuant to the authority granted in paragraph 1) which increase or decrease the par value of the preferred stock or would adversely affect the rights or preferences of the preferred stock, or of the holders thereof. . . .

Article Fourth, Section 1(g) of the Restated Certificate grants the Avatex Board the authority to fix by resolution "the voting rights, if any, of the holders of shares of such series in addition to those given in this Article to all holders of preferred stock." Pursuant to Article Fourth of the Restated Certificate, the Avatex Board has authorized three series of preferred stock.

1. The Avatex First Series Preferred Stock

On March 18, 1983, the same day Avatex filed its Restated Certificate, Avatex filed with the Delaware Secretary of State a certificate of designations authorizing the issuance of 1,100,000 shares of the First Series Preferred Stock and establishing the rights and preferences of such stock (the "First Series Certificate"). Section 6 of the First Series Certificate sets forth the voting rights afforded the holders of the First Series Preferred Stock and explicitly provides that "[e]xcept as expressly provided hereinafter in this

Section (6) or as otherwise from time to time required by law, the First Series Preferred Stock shall have no voting rights." The exception at issue is set forth in Section 6(b) of the First Series Certificate, which reads as follows:

> So long as any shares of the First Series Preferred Stock remain outstanding, the consent of the holders of at least two-thirds of the shares of the First Series Preferred Stock outstanding at the time . . . shall be necessary to permit, effect or validate any one or more of the following:
>
> * * *
>
> (b) The amendment, alteration or repeal, whether by merger, consolidation or otherwise, of any of the provisions of the Restated Certificate of Incorporation or of these resolutions which would materially and adversely affect any right, preference, privilege or voting power of the First Series Preferred Stock or of the holders thereof. . . .

The Restated Certificate and the First Series Certificate are the only corporate documents that define the rights and preferences of the First Series Preferred Stock.

2. The Avatex Second Series Preferred Stock

On September 14, 1983, Avatex filed with the Delaware Secretary of State a certificate of designations authorizing the issuance of 2,900,000 shares of the Second Series Preferred Stock and establishing the rights and preferences of such stock (the "Second Series Certificate"). The Second Series Certificate explicitly provides that "[e]xcept as expressly provided hereinafter . . . or as otherwise from time to time required by law, the Second Series Preferred Stock shall have no voting rights." Section 6 of the Second Series Certificate contains an exception to this restriction nearly identical to the qualified voting rights conferred in the First Series Certificate:

> So long as any shares of the Second Series Preferred Stock remain outstanding, the consent of the holders of at least two-thirds of the shares of the Second Series Preferred Stock outstanding at the time . . . shall be necessary to permit, effect or validate any one or more of the following:
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> * * *

> (b) The amendment, alteration or repeal, whether by merger, consolidation or otherwise, of any of the provisions of the Restated Certificate of Incorporation or of these resolutions which would materially and adversely affect any right, preference, privilege or voting power of the Second Series Preferred Stock and all other series of preferred stock ranking on a parity with Second Series Preferred Stock either as to dividends or the distribution of assets upon liquidation, dissolution or winding up or of the holders thereof. . . .

Unlike the First Series Certificate, Section 6 of the Second Series Certificate further provides the Second Series Preferred Stockholders with the separate and distinct right to vote as a class on certain mergers involving Avatex:

> So long as any shares of the Second Series Preferred Stock remain outstanding, the consent of the holders of at least a majority of the shares of the Second Series Preferred Stock outstanding at the time . . . shall be necessary to permit or approve any of the following:
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> * * *
>
> (b) The consolidation or merger of the Corporation with or into any other corporation unless (i) in connection with such consolidation or merger, provision shall be made to redeem all outstanding shares of Second Series Preferred Stock at the then applicable optional redemption price . . . or (ii) the surviving corporation upon consummation of such consolidation or merger, will have no shares of stock, either authorized or outstanding, which rank prior to the Second Series Preferred Stock as to dividends or as to distribution of assets other than shares of stock issued in exchange for shares of stock of the Corporation which were authorized or outstanding prior to such consolidation or merger, and each holder of shares of Second Series Preferred Stock and all other series of preferred stock ranking on a parity with Second Series Preferred Stock either as to dividends or as to distribution of assets shall receive, upon such consolidation or merger, at least the same number of shares of the surviving corporation with the same rights and preferences, as such holder held immediately preceding such consolidation or merger.

At the present time, Avatex has no outstanding shares of Second Series Preferred Stock. If it did and the terms of the Proposed Merger contemplated the conversion of the Second Series Preferred into common shares of Xetava, clause (ii) of this last quoted provision of Section 6 of the Second Series Certificate would quite clearly grant a right to a class vote to the holders of such shares.

3. The Avatex Series A Preferred Stock

On November 4, 1993, more than ten years after the First and Second Series Preferred Stock were created, Avatex filed with the Delaware Secretary of State a certificate of designations authorizing the issuance of 4,700,000 shares of the Series A Preferred Stock and establishing the rights and preferences of such stock (the "Series A Certificate"). Like the First and Second Series Certificates, the Series A Certificate expressly provides that the Series A Preferred Stock shall have no voting rights, except as required by law or as provided in the Series A Certificate or the Restated Certificate. Unlike the Second Series Certificate, the Series A Certificate does not provide expressly the right to a class vote on any merger. Instead, Section 8(ii) of the Series A Certificate provides class voting rights using language more analogous to that used by Section 6(b) of the First Series Certificate:

> Without the written consent of two-thirds of the outstanding shares of Series A Preferred Stock or the vote of holders of two-thirds of the outstanding shares of Series A Preferred Stock . . . the Company will not. . .amend, alter, repeal or waive any provision of the Certificate of Incorporation or these resolutions so as to adversely affect any preference, right, privilege or voting powers of the Series A Preferred Stock or the holders thereof. . . .

The Restated Certificate and the First Series Certificate are the only corporate documents which define the rights and preferences of the First Series Preferred Stock.

C. The Merger

The agreement and plan of merger adopted by the Avatex board of directors on April 14, 1998 provides for the merger of Avatex with and into Xetava. Xetava is to be the surviving corporation and its certificate of incorporation after the effective date of the merger is to be the same as that immediately prior thereto. The separate corporate existence of Avatex will cease.

In the Proposed Merger, each share of Avatex common stock outstanding immediately prior to the effective time of the Merger (other than shares held in treasury) will be converted into 0.5 share of Xetava common stock. In addition, each share of outstanding First Series Preferred Stock will be converted in the Proposed Merger into 4.129 shares of Xetava common stock, and each share of outstanding Series A Preferred Stock will be converted into 3.7271 shares of Xetava common carry. In the aggregate, the holders of First Series Preferred Stock and Series A Preferred Stock will receive 73.1% of the Xetava common stock, and the holders of Avatex common stock will receive 26.9% of the Xetava common stock.

The Proposed Merger remains subject to approval by a majority of the holders of Avatex common stock as required by 8 *Del. C.* § 251. Accordingly, a special stockholders' meeting is expected to be called later this month at which the Avatex common stockholders are to vote on the Merger. There is no plan to permit the holders of Avatex preferred shares any vote on the Proposed Merger. Nor is there any plan to present for a separate vote any proposal to amend, alter or repeal any provision of the Avatex Restated Certificate or of any of the certificates of designation governing the Avatex preferred stock.

III. DISCUSSION

A. Legal Standard

[1-2] The standard for decision on a motion for judgment on the pleadings, made pursuant to Court of Chancery Rule 12(c), is well-settled. Such a motion "may be granted only when no material issue of fact exists and the movant is entitled to judgment as a matter of law." *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, Del. Supr., 624 A.2d 1199, 1205 (1993). The Court "is required to view the facts pleaded and the inferences to be drawn from such facts in a light most favorable to the non-moving party." *Id.* at 1205; *see also Parnes v. Bally Entertainment Corp.*, Del. Ch., C.A. No. 15192, Chandler, V.C. (Feb. 4, 1998), slip op. at 3.

[3] In deciding this motion, I am called upon to construe the meaning of the several certificates of designations governing the rights of Avatex' preferred stockholders. There is no dispute over the actual language at issue. Nor, at least for the purposes of this motion, is there any dispute over other factual matters, such as plaintiffs' status as stockholders. The dispute is simply whether these governing provisions should be construed to afford the holders of shares of one or more series of Avatex's preferred stock a class

vote on the Proposed Merger.[1] This is an issue of law which can be decided on this motion for judgment on the pleadings. *Warner Communications Inc. v. Chris-Craft Indus., Inc.*, Del. Ch., 583 A.2d 962, 964 (1989), *aff'd without opinion*, Del. Supr., 567 A. 2d 419 (1989) (recognizing that purely legal question of whether preferred stockholders are entitled to a class vote under the certificate of designation appropriately addressed on the pleadings alone.)

B. Class Voting Rights Are Special Contractual Rights and Are Strictly Construed

[4] There is no requirement in the Delaware General Corporation Law ("DGCL") or at common law that preferred shares receive a class or series vote in connection with a merger. Rather, to adopt an agreement of merger, Section 251 of the DGCL requires only the affirmative vote of a "majority of the outstanding stock of the corporation entitled to vote thereon." In this respect, Section 251 is to be contrasted with 8 *Del. C.* § 242(b)(2), which specifically requires a separate class or series vote on certain types of amendments to certificates of incorporation.

[5] Of course, Section 151(a) of the DGCL permits the creation of classes or series of stock having "such voting powers, full or limited, or no voting powers" as "shall be stated and expressed" in the corporate charter or a certificate of designation. Pursuant to this enabling power, Article Fourth of Avatex's Restated Certificate provides, generally, that preferred shares shall have no right to vote on any matter other than those specifically stated in Article Fourth, in a certificate of designation creating a class or series of preferred, or in the DGCL. Similarly, each of the certificates of designations here at issue states that, unless otherwise required by law, the holders of the preferred stock have no voting rights, except as specifically provided therein or in the Restated Certificate. The only pertinent exceptions to this blanket deprivation of preferred voting rights is found in the language of Section 4 of Article Fourth of the Restated Certificate and of Section 6 of the First Series Certificate and Section 8 of the Series A Certificate.[2]

[6-8] The voting rights thus defined by the charter and the certificates of designation are unquestionably contractual in nature. *See, e.g., Wood v. Coastal States Gas Corp.*, Del. Supr., 401 A.2d 932, 937 (1979); *In re*

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[1]In their opening brief, the defendants also argue that the Delaware General Corporation Law ("DGCL") does not separately provide the Avatex preferred stockholders with any right to a class vote on the merger. Plaintiffs do not answer this argument and, thus, concede the point.

[2]The Second Series Certificate also contains a provision specifically and expressly granting class voting rights in connection with certain mergers. This provision also is relevant to the proper interpretation of the provisions of those other certificates.

Appraisal of Ford Holdings, Inc. Preferred Stock, Del. Ch., 698 A.2d 973, 977 (1997) ("To the extent it possesses any special rights or powers and to the extent it is restricted or limited in any way, the relation between the holder of the preferred and the corporation is contractual."). The meaning of these provisions will be "interpreted using standard rules of contract interpretation which require a court to determine, from the language of the contract, the intent of the parties. In discerning the intent of the parties, the Certificate should be read as a whole and, if possible, interpreted to reconcile all of the provisions of the document." *Kaiser Aluminum Corp. v. Matheson*, Del. Supr., 681 A.2d 392, 395 (1996) (citation omitted); *Wood*, 401 A.2d at 937.

[9-11] It also is clearly established under Delaware law that the special contractual rights or preferences of preferred stock must be strictly construed. *See, e.g., Waggoner v. Laster*, Del. Supr., 581 A.2d 1127, 1134-35 (1990) (reviewing the line of earlier decisions and restating that "those decisions clearly establish the rule that stock preferences are to be strictly construed"). "At common law and in the absence of agreement to the contrary, all shares of stock are equal. Thus, unless preferences are expressed 'in clear language' . . . 'they shall not exist.'" E. Folk, R. Ward & E. Welch, Folk on the Delaware General Corporation Law §151.5.1 at §151:19 (3d Ed. 1998) (quoting *Gaskill v. Gladys Belle Oil Co.*, Del. Ch., 146 A. 337, 339 (1929)) (citations omitted). "Nothing is to be presumed in favor of preferences attached to stock, but rather they must be expressed in clear language." *Rothschild Int'l Corp. v. Liggett Group, Inc.*, Del. Ch., 463 A.2d 642, 646 (1983), *aff'd*, Del. Supr., 474 A.2d 133 (1984).

[12-13] Plaintiffs make a series of arguments in support of a broad reading of the relevant certificate provisions and the application of the principle of *contra proferentem* to support an interpretation in favor of the preferred holders. They argue that the voting rights at issue are not "special rights" or "preferences" and, thus, are to be construed broadly, not strictly. They argue that the class vote contended for here is a "carve out" from a forfeiture of voting rights and, thus, should be construed broadly. Finally, they argue that the recent decisions of the Supreme Court in *Kaiser* and *SI Management L.P. v. Wininger*, Del. Supr., 707 A.2d 37 (1998), and of this Court in *Ford Holdings*, without acknowledging the fact, abandoned the long established principle of strict construction applied to the interpretation of the special rights and preferences of preferred stock. None of these arguments is persuasive. *Kaiser*, *SI Management* and *Ford Holdings* all concerned the question of how to resolve an ambiguity in a contract once one is found. None suggest that this Court should abandon long established principles of construction in first determining whether or not an ambiguity exists. Moreover, the law is clearly established that class voting rights are

"special rights" and are to be narrowly construed. *See, e.g., Waggoner*, 581 A.2d at 1134-1135. Class voting rights, where they exist, are in derogation of the common law principle, and the general provisions of Section 212 of the DGCL, that all shares vote equally. *Jedwab v. MGM Grand Hotels, Inc.*, Del. Ch., 509 A.2d 584, 593 (1986); *Sullivan Money Management, Inc. v. FLS Holdings Inc.*, Del. Ch., C.A. No. 12731, Jacobs, V. C. (Nov. 20, 1992), slip op. at 5, n.6, *aff'd without opinion*, Del. Supr., 628 A.2d 84 (1993). Thus, such rights must be "special rights" and are to be strictly construed.

C. The Warner and Sullivan Opinions

Two prior opinions of this Court address issues closely related to the ones presented here. *Warner* and *Sullivan* both rejected claims that charter provisions similar to those at issue here could be read to require a preferred class vote on a merger in which the preferred stock was to be converted into preferred stock of another corporation (*Warner*) or cash (*Sullivan*). *Sullivan* was written after *Warner* and, naturally, relied on its rationale in reaching its conclusion. I will do the same.

In *Warner*, Chancellor Allen considered whether certain provisions of the certificate of designations of a series of preferred stock (the "Series B Preferred") issued by Warner Communications, Inc. ("Warner") entitled the holders thereof to a class vote upon a merger proposed between Warner, its controlling shareholder, Time Warner Inc. ("Time"), and a related subsidiary. In that proposed merger, the Series B Preferred was to be canceled and the holders thereof entitled to receive in exchange for each such share one share of a newly issued Time senior security.

Two provisions of the Series B Preferred certificate of designation were said to require a class vote on the merger. These read as follows:

> Section 3.3(i): [T]he affirmative vote of at least two-thirds of the . . . outstanding shares of Series B Stock . . . shall be necessary to alter or change any rights, preferences of limitation of the Preferred Stock so as to affect the holders of all such shares adversely.
>
> Section 3.4(i): [W]ithout first obtaining the consent or approval of the holders of at least two-thirds of the number of shares of the Series B Stock at the time outstanding . . . the Corporation shall not (i) amend, alter or repeal any of the provisions of the Certificate of Incorporation of By-laws of the Corporation so as to affect adversely any of the preferences,

> rights, power or privileges of the Series B Stock or the holders thereof . . . .

Chancellor Allen first addressed Section 3.4(i), holding that, notwithstanding the fact that Warner's certificate of incorporation would be amended in the merger to eliminate all reference to the Series B Preferred Stock, Section 3.4(i) "does not . . . grant a right to a series vote in these circumstances because the adverse effect upon [the preferred holders] is not caused by an amendment, alteration or repeal of any provision of Warner's certificate of incorporation." *Warner*, 583 A. 2d at 967. Rather, the Court found, "it is the conversion of the Warner Series B Preferred into Time Series BB Preferred that creates the adverse effect" and that conversion would result from the operation of Section 251 of the DGCL and the provisions of the agreement and plan of merger between Warner and Time, not from any amendment to the Warner certificate of incorporation or the Series B Preferred Certificate of Designations. *Id.*

[14] *Warner* also rejected the argument that the somewhat broader language of Section 3.3(i) supported the finding that the holders of the Series B Preferred were entitled to a class vote upon the merger there at issue. Two aspects of the Court's analysis of this issue are particularly relevant here. First, Chancellor Allen noted that Delaware law, for many years, has permitted the conversion of securities, "by merger into 'shares or other securities of the corporation surviving or resulting from [a] merger or consolidation' or into 'cash, property, rights or securities of any other corporation.'" *Warner*, 583 A.2d at 969 (citing 8 *Del. C.* § 251(b); *Federal United Corp. v. Havender*, Del. Supr., 11 A.2d 331 (1940)). From this, he observed, the potential future occurrence of a merger "represents a possibility of the most profound importance to a holder of stock with special rights and preferences." *Id.* (citing Buxbaum, Preferred Stock - Law and Draftsmanship, 42 Calif.L.Rev. 243, 298-309 (1954)). Thus, he implied, any special voting rights relating to mergers or consolidations should be expected to be addressed expressly in the provisions creating such shares, and not by inference or a strained reading of clauses more naturally understood to relate to other events.

Second, Chancellor Allen observed in *Warner* that the Section 3.4(iii) of the Series B Certificate expressly addressed voting rights in the case of mergers (like the Second Series Certificate here) and provided a limited protection not implicated by the terms of the proposed merger between Warner and Time. After examining that provision, the Court concluded that "the only fair inference from Section 3.4(iii) is that it was intended to provide the only certificate-created requirement for a series or class vote

upon a merger," notwithstanding the fact that such a reading threatened to render redundant Section 3.3(i). *Id.* at 971.

D. The Avatex Preferred Have No Right to a Class Vote on the Proposed Merger

[15] Applying the rationale of *Warner* to the case before me leads me to conclude that the provisions governing the First Series Preferred do not allow for a class vote on the Proposed Merger.[3] The particular language of Section 6(b) of the First Series Certificate at issue is as follows:

> [T]he consent of the holders of at least two-thirds of the shares of the First Series Preferred Stock outstanding at the time . . . shall be necessary to permit, effect or validate . . . (b) the amendment, alteration or repeal, *whether by merger, consolidation or otherwise*, of any of the provisions of the Restated Certificate of Incorporation or of these resolutions which would materially and adversely affect any right, preference, privilege or voting power of the First Series Preferred Stock or of the holders thereof. . . .

(Emphasis added). Without the italicized language, this provision would not be distinguishable from Section 3.4(i) of the certificate of designations considered in *Warner*. In my view, the added language only modifies the phrase "amendment, alteration or repeal" and does not independently create a right to a class vote in the case of every merger.

As in *Warner*, the adverse effect about which the holders complain (and which I assume to exist for purposes of this motion) will not flow from any "amendment, alteration or repeal" of the First Series Certificate (however accomplished) but from the conversion into common stock of the First Series Preferred in the Proposed Merger. As Chancellor Allen observed in *Warner*:

> Given that the merger itself is duly authorized, the conversion of the Series B Preferred stock could occur without any prior or contemporaneous amendment to the certificate. Since the merger does contemplate the conversion of the Series B Preferred into the securities of another company, it is to be

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[3]At note 6 of the Elliot plaintiffs' answering brief, it is conceded that prior decisions of this Court hold that no right to a class vote is provided by either Section 242 of the DGCL or Section 8 of the Series A Certificate of Designations. The Harbor plaintiffs also concede these matters by their silence. Thus, I will address my analysis solely to the voting rights of the First Series Preferred.

> expected that the certificate would be amended to reflect the removal of these securities from the firm's capital structure. Section 243 requires such a step as a housekeeping matter, but that section does not require that amendment to be contemporaneous with the retirement of the stock and it surely does not make conversion of the stock dependent upon the amendment it contemplates. Rather, the amendment contemplated is necessitated by the merger; such an amendment, like the conversion, flows from the merger and is not a necessary condition of it. Stated in terms of the language of Section 3.4(i), given the existence of the merger, the amendments of the certificate of incorporation can in no event themselves be said to "affect" [the Series B Preferred holders] "adversely," even if one assumes, as I do on this motion, that the substitution of the Time BB Preferred stock for Warner Series B Preferred stock does have an adverse affect.

Warner, 583 *A.2d* at 967-68 (footnotes omitted). This observation is at least equally apposite here, where Avatex is to be merged with and into Xetava and will simply cease to maintain a separate corporate existence as a matter of law, without the necessity of any amendment, alteration or repeal of its Restated Charter or the First Series Certificate.

[16] Plaintiffs argue strenuously that *Sullivan* requires a different result. I disagree. In *Sullivan*, Vice Chancellor Jacobs found additional support for his conclusion that no class vote was required by examining the certificate of designations of the Junior Preferred Stock (not there at issue). That certificate expressly created a right to a class vote where "either directly or indirectly or through merger or consolidation with any other corporation" the Junior Preferred Stock or the holders hereof would be materially adversely affected by the "amendment, alteration or repeal" of charter or certificate of designations provisions governing those shares. *Sullivan* at 9-10. Although noting that the Junior Preferred Stock were, thus, entitled in some circumstances to a class vote in the event of a merger, the opinion in *Sullivan* did not hold and does not suggest that simply because a certificate of designations contains a class voting provision using the word "merger," there is necessarily a right to a class vote in the case of every merger. Rather, the central rationale of both *Warner* and *Sullivan* requires this Court to examine the source of the threatened material adverse affect. As was true in those cases, the material adverse affect confronting holders of Avatex First Series Preferred shares derives from the threatened conversion of their shares into common stock of the surviving corporation, and not from any "amendment, alteration or repeal" of any of the provisions of the First Series Certificate.

The additional language found in the first Series Certificate but not in Warner does provide for the right to a class vote in circumstances where an "amendment, alteration or repeal" gives rise to a material adverse affect and is accomplished by means other than a Section 242 certificate amendment.[4] Here, however, it is only a matter of housekeeping detail (and of no interest to plaintiffs) whether the charter of the entity surviving the Proposed Merger has or does not have certificate provisions identical to those governing the First Series Preferred, since, by operation of the Proposed Merger, there will be no shares of First Series Preferred outstanding to be affected by the presence or absence of such provisions.

[17] This conclusion is reinforced by a reading of the Avatex Restated Charter as a whole and, in particular, the provision of the Second Series Certificate expressly providing for a right to a class vote in certain mergers. As was true in *Warner*, the presence of such an express provision in the same corporate charter is strong evidence that no other class voting rights in the case of mergers should be inferred or implied. *Warner*, 583 A.2d at 971. Plaintiffs argue, without citation to relevant authority, that the Court should not refer to or rely upon the language of the Second Series Certificate because it was adopted some months after the First Series Preferred shares were issued. I reject this suggestion as contrary to the ordinary understanding that certificates of incorporation are to read as a whole "in order to determine the meaning intended to be given any portion of it." *Ellingwood v. Wolf's Head Oil Ref. Co.*, Del. Supr., 38 A.2d 743, 747 (1944); *Wood*, 401 A.2d at 937; *Warner*, 583 A.2d at 967. In this regard, I note that the class vote on mergers provision found in the Second Series Certificate is not unusual. Indeed, it resembles Section 3.4(iii) of the Warner charter in providing preferred stockholders limited class voting protection in the case of mergers. No comparable provision is found in any provision governing the terms of the First Series Preferred.

The result reached is also supported by a recent decision of the United States District Court for the Northern District of California interpreting a substantially identical certificate of designations provision. *Aaron v. Empresas La Moderna*, No. C. 97-0233 FMS, 1997 WL 564064, Smith, D.J., (N.D.Cal. 1997). There the court followed *Warner* in concluding that "[a] stock conversion pursuant to a merger that adversely affects the

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[4]This reading does not render a nullity the phrase "by merger, consolidation or otherwise," as it is easy to imagine situations where, in connection with a merger or other similar transaction, the holders of First Series Preferred would have a right to a class vote on a proposed "amendment, alteration or repeal" of some provision of the Avatex Restated Certificate or the First Series Certificate proposed in connection with that transaction, although not upon the merger itself. *See* Section 251(b)(3) of the DGCL (resolution approving merger shall specify amendments, if any, to the certificate of the surviving corporation).

preferred stockholders is distinct from changes to a certificate of incorporation following the merger." *Aaron* at *6 (quoting *Warner*, 583 A.2d at 967-68). In my opinion, the *Aaron* court correctly applied Delaware law on the issue and, thus, I recognize its precedential value. Moreover, I agree with the defendants that the decisions in *Warner* and *Aaron* command special deference because the interpretation of more or less standard terms of publicly traded securities, such as those at issue here, is an undertaking in which consistency of outcome is to be valued particularly highly. As our Supreme Court recently had occasion to note:

> Whereas participants in the capital markets can adjust their affairs according to a uniform interpretation, whether its be correct or not as an initial proposition, the creation of enduring uncertainties as to the meaning of boilerplate provisions would decrease the value of all . . . issues and greatly impair the efficient working of capital markets.

Kaiser, 681 A.2d at 398.

IV. CONCLUSION

For all of the foregoing reasons, defendants' motion for judgment on the pleadings is GRANTED. The parties are directed to submit an order on notice.

KAHN v. MSB BANCORP, INC.

No. 14,712-NC

Court of Chancery of the State of Delaware, New Castle

July 16, 1998

Plaintiffs brought individual and class action claims for damages against the corporation and the individual directors for breach of fiduciary

duties. Plaintiffs claimed that the directors acted to entrench themselves and failed to adequately consider offers to purchase the company.

The court of chancery, per Vice-Chancellor Balick, determined that there was no genuine issue of material fact and the conduct in question was not subject to enhanced scrutiny because plaintiffs failed to rebut the business judgment presumption of good faith and due care. The court granted defendants' motion for summary judgment.

1. Corporations ⇐ 312(5)

Under the *Unocal* standard, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred, which applies when a board takes defensive action in response to a threat to its control.

2. Corporations ⇐ 310(1)

There is no reason to apply the *Unocal* standard to a situation where a board of directors merely votes not to negotiate a merger offer, because the board's actions are not defensive and are authorized by statute.

3. Corporations ⇐ 310(1)

It is particularly appropriate to apply the business judgment presumption to a situation where the board has merely voted not to negotiate a merger offer since the board of directors of a corporation is invested with statutory authority to enter into a merger with another company, and there is an implicit recognition that the board may also decline to enter into a merger. DEL. C. ANN. tit. 8, § 251 (1997).

4. Corporations ⇐ 310(1)

The business judgment rule establishes a rebuttable presumption that, in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company.

5. Corporations ⇐ 310(1)

In an effort to overcome the business judgment presumption, an argument that a board's decision was self-interested and directors were motivated to entrench themselves in office must be rejected because: (1) the

fact that nine of the ten directors are outside directors strengthens the presumption of good faith, particularly where the offers included post-merger positions for the board; (2) the mere fact that the directors receive fees for their service is not enough to establish an entrenchment motive; (3) the directors collectively owned about eleven percent of the company stock and would have profited from the rejected offers; and (4) the choice to remain with a long-term strategy at the expense of short-term personal gain indicates a lack of self-interest on the part of the directors.

6. Corporations ⇐ 310(2), 320(11)

To prevail on a claim that a board of directors did not fully inform itself of offers of merger prior to rejecting the offers, plaintiff must prove that the board's behavior amounted to gross negligence.

7. Corporations ⇐ 310(2)

Since the board of directors met weekly, considered the merger offers and consulted with legal and financial advisors prior to deciding to continue with a preexisting transaction rather than a possible merger offer which carried a number of conditions and came at an inopportune time, no triable issue exists that the board failed to act in an informed and reasonable manner in the circumstances.

8. Corporations ⇐ 310(1)

A board's decision to further its long-held business strategy rather than negotiate an unsolicited merger offer was clearly attributable to a rational business purpose.

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Thacher Proffitt & Wood, New York; New York, of counsel, for defendants MSB Bancorp, Inc., Joseph R. Donovan, Joan M. Costello, Douglas Porto, Ralph W. Decker, John L. Krause, John W. Norton, Nicholas J. Scali, Daniel R. Snyder, and Frederick B. Wildfoerster, Jr.

BALICK, *Vice-Chancellor*

Before the court is a motion for summary judgment by defendants MSB Bancorp, Inc. ("MSB") and the ten individuals who comprise MSB's Board of Directors. The plaintiffs have brought individual and class action claims for damages against the individual defendants for breach of their fiduciary duties as directors of MSB. Specifically, the plaintiffs claim that the directors, acting to entrench themselves, failed to adequately consider offers to purchase the company. I find that there is no genuine issue of material fact and that the conduct in question is not subject to enhanced scrutiny. Because plaintiffs have failed to rebut the business judgment presumption of good faith and due care, I will grant the defendants' motion for summary judgment.

BACKGROUND

MSB is organized under Delaware law to serve as a holding company for Middletown Savings Bank, now known as MSB Bank. William C. Myers, who is the President, CEO, and Chairman of MSB, is the only director employed by the bank or holding company. The other nine directors are independent outside directors who receive $18,000 a year for their services, plus $100 for each weekly board meeting they attend. Some of the outside directors receive $50 an hour from the bank for conducting field inspections of properties used as collateral for loans.

MSB is a small local bank in upstate New York. Its Certificate of Incorporation states that, when evaluating merger proposals, the board may consider the social and economic effect of acceptance on its customers and employees, and on the communities in which it operates. Its desire to remain an independent, community-oriented bank has been evident in its long-term business plan since 1989. MSB's strategic plan anticipated growth through acquisitions and branch expansions into neighboring markets. In the late eighties and early nineties, MSB acquired a number of branches from other financial institutions in its service area.

In 1994, MSB engaged an investment banker, Bear Stearns, to advise it on possible future acquisitions. Bear Stearns identified certain branches of First Nationwide Bank as a potential acquisition target. MSB requested that Bear Stearns communicate its interest in acquiring the branches to First