Nationwide. Recognizing that MSB was itself an attractive acquisition target, MSB also asked Bear Stearns to analyze its potential merger and acquisition value. Bear Stearns valued MSB in the range of $35 - $40 per share.

In August of 1994, Albank Financial Corporation sent a written expression of interest in purchasing MSB for $31 to $32 per share. Bear Stearns analyzed the offer and compared it with other opportunities such as the First Nationwide branch acquisition. After consultation with Bear Stearns and other advisors, the board decided not to pursue Albank's expression of interest and to continue its plan to acquire additional branches.

By July of 1995, First Nationwide had decided to sell clusters of its branches, including an eight-branch cluster in MSB's service area. MSB participated in a bidding process and was ultimately successful. To make its bid more attractive, a $4.9 million break-up fee was included. MSB planned to finance the purchase with a public stock offering. Because Bear Stearns stood to gain a fee for underwriting the stock offering, MSB sought a second opinion on the First Nationwide purchase from FinPro, an investment bank not affiliated with Bear Stearns.

In July and September of 1995, while MSB was negotiating a definitive agreement with First Nationwide, the board received two unsolicited offers to merge with HUBCO, a bank holding company in Union City New Jersey. The first letter contained no proposed price, but rather invited further discussions. The second letter suggested a price of $35 worth of HUBCO stock, but contained no other specific terms. After considering Bear Stearns' analysis of the HUBCO offer, the board voted to go forward with a definitive agreement with First Nationwide to purchase the eight branches in MSB's service area. In September, MSB informed HUBCO that it was not interested in pursuing a merger.

Despite the fact that MSB had declined HUBCO's invitation to negotiate a merger and was in the process of completing the First Nationwide transaction, HUBCO representatives met with Mr. Myers and other board members in late October to discuss HUBCO's continuing interest in merging with MSB. At the meeting, HUBCO presented another offer, this time at a price of $25 of HUBCO shares. HUBCO attributed the $10 reduction in the merger price to MSB's impending purchase of the First Nationwide branches. HUBCO did not ask that MSB cancel the upcoming purchase, but did condition its offer on MSB's agreement to cancel the public stock offering. HUBCO did not specify how they would finance the purchase of the First Nationwide branches if the public stock offering was canceled. After discussing the HUBCO offer, the MSB board rejected it in order to proceed with the First Nationwide acquisition as planned.

As MSB was preparing for the stock offering to finance the First Nationwide transaction, Robert Wilmers, President and CEO of First Empire State Corporation, delivered an unsolicited merger proposal to each of the MSB directors in the middle of the night. First Empire proposed a merger price of $26 per share in cash or stock and called for no due diligence of any kind. Its offer was accompanied by a 44-page proposed "Agreement and Plan of Merger." Unlike the Albank and HUBCO proposals, this was clearly a firm offer. MSB contacted Bear Stearns for a formal opinion letter and sought the advice of counsel. After discussing its options at two separate meetings, the board rejected the First Empire offer in favor of continuing with the First nationwide transaction.

In November of 1995, the plaintiffs brought this suit alleging that the MSB directors breached their fiduciary duties of care and loyalty in rejecting the HUBCO and First Empire offers and failing to disclose the offers to MSB's shareholders. Because the plaintiffs now press only the claim related to MSB's rejection of the HUBCO offer, there is no need to discuss the Albank and First Empire offers or the disclosure allegations.

ANALYSIS

The parties disagree on the appropriate level of judicial scrutiny of the board's actions. The defendants assert that the board's actions enjoy the business judgment rule's presumption of good faith and due care, while the plaintiffs urge the court to apply the somewhat more strict Unocal standard. [1] Under Unocal, "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[1] Unocal applies when a board takes defensive action in response to a threat to its control.[2] Here, there was no defensive action. The board merely voted not to negotiate the merger offer.

The plaintiffs acknowledge that the board's rejection of a merger offer did not amount to a defensive action as required by Unocal and later cases. Instead, the plaintiffs urge the court to adopt a new rule that a board should be required to persuade the court that it has acted in good faith and with due care when it rejects a merger offer. The plaintiff concedes that Unocal's further requirement that the directors show that they reacted reasonably and in proportion to the perceived threat is irrelevant where, as here, no defensive action was taken.

---

[1]Unocal v. Mesa Petroleum, Del. Supr., 493 A.2d 946, 954 (1985).

[2]Unitrin, Inc. v. American Gen. Corp., Del. Supr., 651 A.2d 1361, 1372 n. 9 (1995); Stroud v. Grace, Del. Supr., 606 A.2d 75, 82 (1992); Gilbert v. El Paso, Del. Supr., 575 A.2d 1131, 1144 (1990).

[2-3] The plaintiffs proposed rule would depart from precedent. Because the board's actions were not defensive and were authorized by statute, there is no reason to apply the Unocal standard. Moreover, it is particularly appropriate to apply the business judgment presumption in this case because the board of directors of a corporation is invested with statutory authority under 8 Del. Code § 251 to enter into a merger with another company.[3] That statute carries with it an implicit recognition that the board may also decline to enter into a merger.

[4] 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."[4] The plaintiffs argue that the evidence in the record is sufficient to create a triable issue that the board breached its fiduciary duties.

[5] In an effort to overcome the business judgement presumption, the plaintiffs contend that the board's decision was self-interested, because the directors were motivated to entrench themselves in office. This contention must be rejected for several reasons. First, the fact that nine of the ten directors are not employed by MSB, but are outside directors, strengthens the presumption of good faith.[5] Moreover, HUBCO's offers included post-merger positions for Mr. Myers and the rest of the board. Second, the mere fact that the directors receive fees for their service is not enough to establish an entrenchment motive.[6] Third, the directors collectively own about 11% of MSB's stock and would have profited handsomely from the rejected offers. The choice to remain with a long-term strategy at the expense of short-term personal gain indicates, if anything, a lack of self-interest on the part of the directors. In these circumstances, the evidence is insufficient to create a triable issue of an improper entrenchment motive.

[6-7] The plaintiffs also allege that the board did not fully inform itself of the HUBCO offers before rejecting them in favor of its existing plan to acquire additional branches from First Nationwide. To prevail on this issue, the plaintiffs must prove that the board's behavior amounted to gross negligence.[7] During the period in question, the board met weekly, considered the offers, consulted with its legal and financial advisors, and then concluded that it would be best to continue with its imminent acquisition of the First Nationwide branches. The HUBCO offers carried a number of conditions and came at an inopportune time. The board was in

---

[3]Unitrin, 651 A.2d at 1375 n. 16.
[4]Aronson v. Lewis, Del. Supr., 473 A.2d 805, 812 (1984).
[5]Polk v. Good, Del. Supr., 507 A.2d 531, 537 (1986).
[6]Grobow v. Perot, Del. Supr., 539 A.2d 180, 188 (1988).
[7]Smith v. Van Gorkum, Del. Supr., 488 A.2d 858, 873 (1985).

the process of undertaking a public offering to finance the First Nationwide transaction. If the board jeopardized the First Nationwide transaction by abandoning the stock offering as the HUBCO offer required, MSB stood to lose not only the break-up fee, but also the opportunity to buy a cluster of existing branches in its service area. These branches would then become available for purchase by a competitor. In addition, because the offers were conditional, the HUBCO merger was not certain to occur. The board chose to continue the First Nationwide transaction rather than endanger it for a possible merger with HUBCO. The record does not raise a triable issue that the board failed to act in an informed and reasonable manner in the circumstances.

[8] The record is insufficient, as a matter of law, to overcome the presumption that the directors made a well-informed decision that they believed was in the best interests of MSB. The board's decision to purchase the First Nationwide branches in furtherance of its long-held business strategy rather than negotiate an unsolicited merger offer was clearly attributable to a rational business purpose. I will therefore enter the attached order granting the defendants' motion for summary judgment.

ORDER

For the reasons stated in the memorandum opinion filed with this order, it is ordered that the defendants' motion for summary judgment is granted.

ROVNER v. HEALTH-CHEM CORP.

No. 15,007

Court of Chancery of the State of Delaware, New Castle

April 23, 1998

Plaintiffs, shareholders in defendant corporation, petitioned for an award of attorneys' fees and expenses in connection with a lawsuit that was

rendered moot as a result of defendant's decision to amend their stock purchase agreement.

The court of chancery, per Chancellor Chandler, granted plaintiffs petition for attorneys' fees and expenses. The court found plaintiffs' claim satisfied all three prongs of the corporate benefit doctrine because (1) the claim was meritorious, (2) there was a causal connection between the initiation of the lawsuit and the subsequent benefit to the stockholders, and (3) a benefit was conferred upon the stockholders.

1. Attorney and Client ⚿ 155
   Corporations ⚿ 189(14), 214
   Costs ⚿ 194.24, 194.48

Under the common corporate benefit doctrine, a class representative or derivative plaintiff who confers a common monetary benefit upon an ascertainable stockholder class is entitled to an award of counsel fees and expenses for its efforts in creating the benefit.

2. Attorney and Client ⚿ 155
   Corporations ⚿ 189(14), 214
   Costs ⚿ 194.48

Attorney fees may be awarded to plaintiffs' counsel even where a defendant corporation takes steps to settle or moot a case and in so doing produces a benefit similar to that sought by the shareholders' litigation.

3. Attorney and Client ⚿ 155
   Corporations ⚿ 189(14), 214
   Costs ⚿ 194.48

Where a defendant corporation takes steps to settle or moot a case and in so doing produces a benefit similar to that sought by the shareholders' litigation, the only way a defendant corporation may escape responsibility for counsel fees is to show either that the lawsuit was not meritorious when filed, that no causal connection existed between the initiation of the lawsuit and any later benefit to the shareholders, or that no benefit was conferred.

4. Attorney and Client ⟹ 155
Corporations ⟹ 189(14), 214
Costs ⟹ 171

For the purpose of considering an application for counsel fees and expenses, a claim is considered meritorious if it can withstand a motion to dismiss on the pleadings and, at the same time, the plaintiff possesses knowledge of provable facts which hold out some reasonable likelihood of ultimate success.

5. Attorney and Client ⟹ 155
Corporations ⟹ 214
Costs ⟹ 171

The meritoriousness of the claim does not turn on whether the plaintiffs would have ultimately prevailed on their claims, but rather on whether plaintiffs' claims had a reasonable hope of success when filed.

6. Attorney and Client ⟹ 155
Corporations ⟹ 214

Where defendants seriously do not dispute that plaintiffs' claims were meritorious when filed, the plaintiffs have satisfied the first requirement of the corporate benefit doctrine.

7. Attorney and Client ⟹ 155
Corporations ⟹ 189(14), 214

In opposing an application for fees, defendants have the burden of showing there was no causal connection between the initiation of the lawsuit and any subsequent benefit to the shareholders; this rebuttable presumption exists because it is the defendant, and not the plaintiff, who is in a position to know the reasons, events and decisions leading up to the defendant's action.

8. Corporations ⟹ 214

In rebutting the presumption that there was a causal connection between initiation of a lawsuit and subsequent benefit to shareholders under the corporate benefit doctrine, defendants were required to prove plaintiffs' lawsuit did not in any way cause them to modify a stock purchase agreement.

9. Attorney and Client ⟹ 155
Corporations ⟹ 158, 214

Whereas a result of plaintiffs' lawsuit, defendant retained valuable stock options thus increasing the stock's public float and further benefiting the company, benefits that accrued to defendant shareholders were not great, but were still real and substantial entitling plaintiffs to an award of attorneys' fees.

10. Attorney and Client ⟹ 155
Corporations ⟹ 214

The fact that defendants expended significant resources to defend against plaintiffs' claims does not diminish benefits conferred on defendant stockholders under the corporate benefit doctrine.

11. Corporations ⟹ 214
Costs ⟹ 151, 171, 194.48

The court will employ a *quantum meruit* approach to determine attorneys' fees to be awarded to plaintiffs, where the court, after reviewing the record, including plaintiffs' experts' affidavit on the value of the retained options, believes that the benefits conferred to defendants shareholders are speculative.

William Prickett, Esquire, Elizabeth M. McGeever, Esquire, Ronald A. Brown, Jr., Esquire, and Bruce E. Jameson, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware, for plaintiffs.

Michael D. Goldman, Esquire, Peter J. Walsh, Jr., Esquire, Kevin R. Shannon, Esquire, and Michael A. Pittenger, Esquire, of Potter Anderson & Corroon, Wilmington, Delaware; and Evan Slavitt, Esquire, and Carol Didget, Esquire, of Hinckley, Allen & Snyder, Boston, Massachusetts, of counsel, for defendant Health-Chem Corporation.

Andre G. Bouchard, Esquire, and Joel Friedlander, Esquire, of Bouchard, Friedlander & Maloneyhuss, Wilmington, Delaware, for defendant Marvin M. Speiser.

Henry E. Gallagher, Jr., Esquire, of Connolly, Bove, Lodge & Hutz, Wilmington, Delaware, for defendants Gregory P. Speiser, Robert D. Speiser, Steven Bernstein, Samuel R. Goodson, Paul R. Moeller, Bruce M.

Schloss, Matthew Goldstein, Martin Benis, Eugene Roshwalb, and Milon Zussman.

CHANDLER, *Chancellor*

Before the Court is plaintiffs' counsels' application for fees and expenses in connection with a lawsuit that was rendered moot as a result of defendants' decision to amend their Stock Purchase Agreement. Because plaintiffs' counsel have satisfied all three requirements of the "common corporate benefit" doctrine, they are entitled to attorneys' fees and expenses.

I. BACKGROUND

The background of this lawsuit is set forth in detail in a prior opinion issued in connection with this lawsuit.[1] Therefore, I will provide only a brief recitation of the operative facts.

Plaintiffs Herman Rovner and Bruce Nicholl (collectively, "plaintiffs") are Health-Chem shareholders. Plaintiffs brought this action individually, as a class action on behalf of Health-Chem stockholders, and derivatively on behalf of Health-Chem.

Defendant Health-Chem Corporation ("Health-Chem") is incorporated in Delaware. Through its subsidiaries, Health-Chem develops and markets products connected with laminated or coated films used in the health care, pharmaceutical, and environmental industries. Health-Chem has approximately 8,000,000 shares of outstanding common stock that is traded on the American Stock Exchange.

Defendant Marvin M. Speiser ("Speiser") is the Chairman of the Board and President of Health-Chem. Speiser owned 3,565,946 shares of Health-Chem. However, 1,782,689 of those shares (the "Option Shares") were subject to two repurchase option agreements, one dated 1991 (the "1991 Option Agreement") and the other dated 1994 (the "1994 Option Agreement").[2]

---

[1]*See Rovner v. Health-Chem Corp.*, Del. Ch., C.A. 15007, Chandler, V.C. (July 3, 1996).

[2]The 1991 and 1994 Option Agreements came about in part because Health-Chem was (and continued to be) subject to a debt indenture agreement. Pursuant to the indenture's terms, Health-Chem may not purchase its own shares unless it finances the purchase with a concurrent sale of the Company's stock or uses retained earnings. Since the Company did not have the requisite amount of retained earnings, it had to sell some of its own shares to exercise its options under the 1991 and 1994 Agreements.

A. *The 1991 and 1994 Option Agreements*

Speiser acquired most of the shares subject to the 1991 Option Agreement from his former business partner, Leon C. Baker ("Baker"). Pursuant to the 1991 Option Agreement,[3] Speiser purchased all of Baker's shares for $377,377, and granted Health-Chem (until June 30, 1999) an option to purchase 1.2 million shares from him for $377,377 plus interest.

Pursuant to the terms of the 1994 Option Agreement, Health-Chem sold Speiser 575,000 shares, and was granted (until June 30, 1999) an option to repurchase the shares from Speiser for $2 per share plus interest.

The terms of both the 1991 and 1994 Option Agreements contain an all-or-nothing provision requiring Health-Chem to purchase *all* the shares subject to the Option Agreement, rather than just a portion of the shares. These Agreements also include a provision requiring Speiser to vote the Option Shares in proportion to the vote of all other outstanding shares. Thus, while Speiser owned approximately 45% of the outstanding common stock, he actually controlled only 28.76% of the voting power. As a result, 30% of the other shareholders were required to vote with Speiser in order for him to obtain a majority vote in favor of his propositions.[4]

B. *The Rights Offering and the Stock Purchase Plan*

On March 29, 1996, with full board approval,[5] Speiser and Health-Chem entered into the Stock Purchase Agreement. Pursuant to this Agreement, Health-Chem would issue subscription rights to its current shareholders, except Speiser, allowing the holders of these rights to purchase up to 1,320,000 shares of Health-Chem common stock during a period of time to be determined, between fifteen and forty-five days (the "Rights Offering"). The subscription rights would allow current shareholders to purchase three new shares of Health-Chem stock for every ten shares that they owned.[6]

Health-Chem planned to use the proceeds from the Rights Offering to exercise its options to purchase up to 1,269,820 Option Shares from

---

[3]*See In re Health-Chem Corp. Shareholders Litig.*, Del. Ch., C.A. No. 8995, Allen, C. (June 7, 1991)(ORDER), at 2.

[4]In my earlier opinion, I found that neither of the Option Agreements restricted the parties from renegotiating the terms or modifying the agreement.

[5]Speiser, and his sons, who were also board members, abstained from voting. The board adopted a resolution granting the special committee (which had recommended the transaction) the authority to establish a record date for the transaction and to finalize its terms.

[6]At the time that plaintiffs filed their complaint, Health-Chem had not yet determined the price at which shareholders could exercise their subscription rights, but anticipated that the price would be close to the price that Health-Chem would pay Speiser for the Option Shares.

Speiser (the "Stock Purchase"). Speiser and Health-Chem agreed to establish a purchase price based on the weighted average exercise price of the 1991 and 1994 Option Agreements. Speiser and Health-Chem also agreed that they would amend the 1991 and 1994 Option Agreements to allow Health-Chem to purchase just a portion of the shares, rather than all of them.

Significantly, the Stock Purchase Agreement did not provide for a minimum subscription rate which, if not met, would trigger a mechanism to protect Health-Chem and its public shareholders if the Rights Offering was under-subscribed. Rather, under the Stock Purchase Agreement, Speiser would retain all of the Option Shares that Health-Chem was unable to purchase, free of the requirements imposed by the Option Agreements. Thus, Speiser's voting power could have increased significantly after the transactions were completed if the Rights Offering was under-subscribed. Notably, if the parties had not entered into this transaction, and were unable to devise another transaction that would fall within the constraints discussed previously, then in 1999, both Option Agreements would expire. In that case, Speiser would own *all* the Option Shares, free of any restrictions.[7]

C. *Injunctive Relief Denied*

On April 8, 1996, in connection with its annual meeting, Health-Chem distributed a proxy statement that described the Rights Offering and Stock Purchase Agreement. Shortly thereafter, plaintiffs filed a complaint on behalf of themselves as individuals and the other shareholders as a class against Health-Chem, Speiser and the board of directors alleging: (1) breach of the fiduciary duty of loyalty and good faith; (2) breach of contract and court approved settlement; and (3) breach of the duty to disclose. Among other relief, plaintiffs sought an injunction against the consummation of the Stock Purchase Agreement and Rights Offering. Alternatively, plaintiffs sought an amendment to the Stock Purchase Agreement that would require the 1991 and 1994 Option Agreements to remain in force with respect to any shares Health-Chem did not purchase from Speiser. Plaintiffs also asked the Court to declare the Stock Purchase Agreement a waste of assets, and to

---

[7]Speiser owned shares that were not governed by any Option Agreement that entitled him, like all other shareholders, to receive subscription rights. Speiser agreed, however, not to participate in the Rights Offering because he wished to avoid potential liability under Section 16(b) of the Securities Exchange Act of 1934 (which precludes company insiders such as Speiser from making short-swing profits). Therefore, Health-Chem and Speiser structured the transaction so that Speiser would retain the number of Option Shares that he would have been entitled to purchase if he had participated in the Rights Offering. Accordingly, under the Stock Purchase Agreement, Speiser would retain 512,869 Option Shares free of Health-Chem's option to repurchase, and without any voting or transfer restrictions.

award damages to the stockholders on the basis that the proxy statement was misleading.

After hearing oral argument on plaintiffs' motion for a preliminary injunction, I found that plaintiffs had failed to demonstrate a probability of success on their claim that the Stock Purchase Agreement violated the Court's Order and Final Judgment of June 7, 1991. Consequently, plaintiffs' corresponding disclosure claim was also rendered invalid. As to the remainder of plaintiffs' claims, I held that plaintiffs had failed to demonstrate that they would suffer irreparable injury if injunctive relief were denied. Therefore, I denied plaintiffs' motion.[8]

D. *The Rights Offering*

On August 2, 1996, Health-Chem commenced the Rights Offering, pursuant to which Health-Chem offered to sell 1,269,920 shares. Health-Chem shareholders purchased a total of 952,520 shares, representing 75% of the shares offered. Accordingly, under the terms of the Stock Purchase Agreement, Speiser was entitled to keep 317,400 shares free of the restrictions included in the 1991 and 1994 Option Agreements, and Health-Chem was required to relinquish its right to purchase these shares from Speiser.[9]

E. *The Amended Stock Purchase Agreement*

On September 17, 1996, the day after the Rights Offering closed, Health-Chem and Speiser entered into an agreement that modified the terms of the Stock Purchase Agreement. Under the amended terms, Health-Chem's rights under the 1991 and 1994 Option Agreements were preserved. Accordingly, Health-Chem's option to repurchase Speiser's 317,400 shares would remain in effect until 1999, and until that time, Speiser would vote his 317,400 shares in proportion to the votes of Health-Chem's other shareholders.

F. *Dismissal of the Case and Attorneys' Fees*

Plaintiffs moved to dismiss and petitioned the Court for an award of attorneys' fees based on the amendments to the Stock Purchase Agreement. Because I agree with plaintiffs that these claims have been rendered moot,

---

[8]The Delaware Supreme Court refused to accept an appeal from my Order. *Rovner v. Health-Chem Corp.*, Del. Supr., No. 285 (July 23, 1996) (ORDER).

[9]Thereafter, defendants filed a motion to dismiss, for summary judgment, and to disqualify plaintiffs as class and derivative representatives.

I grant the parties' motion and dismiss this action with prejudice. Further, because I find plaintiffs' claims satisfy all three prongs of the "common corporate benefit" doctrine, I grant plaintiffs' petition for attorneys' fees.

II. DISCUSSION

[1-3] Under the common corporate benefit doctrine, a class representative or derivative plaintiff "who confers a common monetary benefit upon an ascertainable stockholder class is entitled to an award of counsel fees and expenses for its efforts in creating the benefit."[10] Attorney fees may be awarded to plaintiffs' counsel even where, as here, a defendant corporation takes steps to settle or moot a case and in so doing produces a benefit similar to that sought by the shareholders' litigation.[11] In this circumstance, the only way a defendant corporation may escape responsibility for counsel fees is to show either that the lawsuit was not meritorious when filed, that no causal connection existed between the initiation of the lawsuit and any later benefit to the shareholders, or that no benefit was conferred.[12] I find in this case that the lawsuit was meritorious when filed and that it had a causal connection to the conferred benefit.

A. *The Meritorious Claim*

[4-6] For the purpose of considering an application for counsel fees and expenses, a claim "is considered meritorious if it can withstand a motion to dismiss on the pleadings and, at the same time, the plaintiff possesses knowledge of provable facts which hold out some reasonable likelihood of ultimate success."[13] That is, the meritoriousness of the claim does not turn on whether plaintiffs would have ultimately prevailed on their claims, but rather on whether plaintiffs' claims had a "reasonable hope" of success when filed.[14] Defendants seriously do not dispute that plaintiffs' claims were meritorious when filed (and stated as much during oral argument in connection with plaintiffs' petition for attorneys' fees). Accordingly, I find that plaintiffs have satisfied the first requirement of the corporate benefit doctrine.

---

[10] *United Vanguard Fund, Inc. v. Takecare, Inc.*, Del. Supr., 693 A.2d 1076, 1079 (1997).

[11] *Allied Artists Pictures Corp. v. Baron*, Del. Supr., 413 A.2d 876, 878 (1980).

[12] *United Vanguard Fund*, 693 A.2d at 1080 (1997).

[13] *Roizen v. Multivest, Inc.*, Del. Ch., C.A. No. 6535, Brown, C. (Dec. 27, 1982), slip op. at 6.

[14] *Allied Artists Pictures Corp.*, 413 A.2d at 879 (quoting *Chrysler Corp. v. Dann*, Del. Supr., 223 A.2d 384, 387 (1966)).

B. *Causal Connection*

[7-8] In opposing this application for fees, defendants have the burden of showing there was no causal connection between the initiation of the lawsuit and any subsequent benefit to the shareholders.[15] "This rebuttable presumption exists because it is the 'defendant, and not the plaintiff, who is in a position to know the reasons, events and decisions leading up to the defendant's action.'"[16] Therefore, defendants are required to prove that plaintiffs' lawsuit did not in any way cause them to modify the Stock Purchase Agreement allowing Health-Chem to retain its rights under the 1991 and 1994 Stock Purchase Agreements.

Defendants insist that plaintiffs' lawsuit did not influence their decision to modify the Stock Purchase Agreement. They assert that Speiser had always intended for Health-Chem to retain its rights to the Options under the 1991 and 1994 Agreements and maintain that Speiser had hoped (and expected) that the Rights Offering would be fully subscribed. I find, however, that defendants provide no credible evidence to support this assertion.

C. *Benefit Conferred*

Defendants' strongest argument for denying plaintiffs' petition for attorneys' fees is that their lawsuit did not produce any tangible benefit for the class. Defendants argue that the minimal benefits that could possibly be attributed to plaintiffs' litigation (which defendants vehemently deny) are dwarfed by the amount Health-Chem was forced to spend to defend against plaintiffs' suit. Defendants flatly reject plaintiffs' expert's valuation of the Option shares in the range of $220,000, and claim that such valuation was flawed and overstated. Defendants further argue that even if the retention of the Options has some minimal value, it is unlikely that the Company would be in a position to exercise its Options prior to their expiration (in 1999) because of the Company's cumulative earnings deficit, outstanding debentures and poor performance in recent years.

[9-10] Ultimately, I am not persuaded by this argument, especially on the existing record. Although the benefits that accrued to Health-Chem shareholders were not great, they were still real and substantial. As a result of plaintiffs' lawsuit, Health-Chem retained 317,400 valuable Options. Further, it is not inconceivable that Health-Chem will conduct another

---

[15] *United Vanguard Fund Inc.*, 693 A.2d at 1080 (citing *Tandycrafts*, 562 A.2d at 1167; *Allied Artists*, 413 A.2d at 880).

[16] *Id.* (quoting *Allied Artists*, 413 A.2d at 880).

Rights Offering sometime before 1999, thus increasing the stock's public float and further benefiting the Company. Finally, I note that the fact that defendants expended significant resources to defend against plaintiffs' claims does not diminish these benefits. Accordingly, plaintiffs are entitled to an award of attorneys' fees.

III. CONCLUSION

Plaintiffs request attorneys' fees in the amount of $100,000 and $26,128 for expenses incurred in prosecuting this lawsuit and defending a related lawsuit in federal court in New York.[17] Plaintiffs' attorneys state that the amount they now seek accounts for less than the actual amount of time that they expended.[18] Plaintiffs maintain that an award of $100,000 is reasonable in light of the benefit conferred, the standing and ability of counsel, and the complexity and contingent nature of the suit.

[11] As discussed earlier, plaintiffs' expert found the value of the retained Options to be in the range of $220,000. This Court has always accepted such valuations with a healthy dose of skepticism.[19] Further, after reviewing the record, including the plaintiffs' experts' affidavit on the value of the retained Options, I believe that the benefits conferred to Health-Chem shareholders are speculative. Accordingly, I have employed a *quantum meruit* approach to determine the attorneys' fees to be awarded to plaintiffs.[20] After considering the benefits conferred, the work the attorneys performed to achieve the benefits, the number of hours and value of attorney time expended, and the contingent nature of the lawsuit, I award plaintiffs' attorneys $74,600 and $26,128 to cover fees and expenses, respectively.

Counsel shall submit a form of order.

---

[17]Plaintiffs' attorneys maintain that defendants brought the New York action to derail this case. According to plaintiffs' attorneys, defendants moved the federal court to enjoin the case on the eve of the injunction hearing; the motion was denied pursuant to the Anti-Injunction Act, 28 U.S.C. § 2238.

[18]Specifically, plaintiffs' attorneys assert that the time they expended in the Chancery action amounts to $119,000 and the time expended in the New York action amounts to $51,000.

[19]*See, e.g., Lewis v. Vogelstein*, Del. Ch., C.A. No. 14954, Allen, C. (March 11, 1997), slip op. at 7 (holding that the Black-Scholes option-pricing formula did not provide a sufficiently reliable estimate). *See generally* Fisher Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. Pol. Econ. 637 (1973).

[20]*See Roizen v. Multivest, Inc.*, Del. Ch., C.A. No. 6535, Brown, C. (Dec. 27, 1982); *Dann v. Chrysler Corporation*, Del. Ch., 215 A.2d 709, 718-19 (1965), *aff'd.*, Del. Supr., 223 A.2d 384 (1966).

SIEGMAN v. PALOMAR MEDICAL TECHNOLOGIES, INC.

No. 15,894

Court of Chancery of the State of Delaware, New Castle

July 13, 1998

Plaintiff, a common stock shareholder of the defendant corporation, filed a motion for an award of attorneys' fees and expenses, incurred as the result of an unsuccessful action challenging the validity of a series of preferred stock. The plaintiff contended that attorneys' fees should be awarded despite the outcome of the underlying action because: (1) the claim was meritorious when filed, (2) the action itself caused the defendants to correct the invalidity complained of, and (3) the correction of the invalidity of the preferred stock conferred a substantial and important benefit upon the defendant corporation and its shareholders.

The court of chancery, per Vice-Chancellor Jacobs, after rejecting a threshold defense of judicial estoppel, determined that the plaintiff was entitled to attorneys' fees, albeit less than the amount requested, because: (1) the series of preferred stock was invalid when issued and remained invalid until certificates of correction were filed, after the lawsuit was underway; (2) the lawsuit induced the defendants to file the certificates of correction, which substantively validated the preferred stock; and (3) the validation of the preferred stock avoided potential liability from securities litigation, and thus conferred a substantial compensable benefit to the defendant corporation and its shareholders. Under the *quantum meruit* analysis, $125,000 constituted adequate compensation for plaintiff's counsel, where the case was taken on a contingency basis and the work created the benefit. Counsel was not entitled to compensation for any additional work that did not contribute to the benefit.

1. Estoppel ☞ 68(2)

Under the doctrine of judicial estoppel, a party may be precluded from asserting a position that is inconsistent with a position taken by that party in the same or in an earlier legal proceeding.

2. Estoppel ☞ 68(2)

Judicial estoppel prevents a litigant from advancing an argument that contradicts a position previously taken by that same litigant, where the

previous position has been accepted by the court as the basis for its ruling, but not where the court has neither accepted nor relied upon the litigant's earlier position.

3. Attorney and Client ⟹ 155
Corporations ⟹ 189(14), 214
Costs ⟹ 172, 194.16

The applicable standard on a motion for attorneys' fees, where a plaintiff continues litigating after defendant's action renders the claim moot, is (1) the plaintiff's claim must have been meritorious when filed, (2) the defendants must have taken action that was causally related to the plaintiff's claims before those claims were judicially resolved, and (3) the action taken must have benefited the corporation or its stockholders.

4. Statutes ⟹ 188

Delaware's General Corporate Law section 103, governing the correction of an inaccurate record of corporate action, contains no demand requirement; and, where the parties show no basis for doing so, the court will not read such a requirement into the statute. DEL. CODE ANN. tit. 8, § 103(f) (1997).

5. Attorney and Client ⟹ 155
Corporations ⟹ 189(14), 214
Costs ⟹ 172

Where the series of preferred stock that the plaintiff complained of was deemed invalid *ab initio* by the court, and where the invalidity was not corrected by the defendant corporation until the action was well underway, the requirement that the plaintiff's claim be meritorious when filed is met.

6. Attorney and Client ⟹ 140
Corporations ⟹ 189(14), 214

In determining a reasonable award of attorneys' fees, the benefit achieved by the litigation is accorded the greatest weight among the factors considered by the court.

7. Corporations ⚿ 189(14), 214

Where litigation induced the defendant corporation to file certificates of correction, the court found that a significant benefit, for fee awarding purposes, had been conferred upon the corporation and its stockholders because the certificates of correction: (1) furnished the corporation and its shareholders with reliable information about the validity of a series of preferred stock, and (2) substantively validated the preferred stock, thereby avoiding potential damage liability and costly securities litigation.

8. Corporations ⚿ 214

For fee awarding purposes, the correction of improper disclosures in a tender offer disclosure document constitutes a fee-compensable benefit, because where a representative shareholder succeeds in correcting invalid disclosures in connection with a transaction, the corporation and all of its shareholders are benefited.

9. Corporations ⚿ 214

When applying *quantum meruit* to determine the reasonable amount of attorneys' fees, the court must take into account: (1) the time and effort expended by the plaintiff's counsel, (2) the complexity and difficulty of the case, (3) whether the representation was contingent in nature, (4) the standing and ability of plaintiff's counsel, and (5) the benefit conferred.

10. Corporations ⚿ 189(14), 214

In determining a reasonable amount of attorneys' fees to be awarded, the court will compensate the plaintiff's counsel for the time and effort required to bring about the benefit; but the court will not compensate plaintiff's counsel for subsequent efforts that did not result in a compensable benefit.

11. Corporations ⚿ 189(14), 214

Where the benefit conferred is significant, but intangible and incapable of precise quantification, a reasonable award of attorneys' fees cannot be predicated on the value of the benefit; rather, the court will award a fee that is based on the financial risks incurred by taking on the case, including whether the case was taken on a contingency basis, and on the work done that created the benefit.

12. Corporations ⚷ 189(14), 214

Plaintiff cannot be faulted for pressing a claim that was ultimately unsuccessful, where at the time it was filed its success was unknowable, but the court will not award attorneys' fees for litigative efforts that turned out to be unsuccessful.

William Prickett, Esquire, Ronald A. Brown, Jr., Esquire, Thomas A. Mullen, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware; and Arthur T. Susman, Esquire, and Charles R. Watkins, Esquire, of Susman & Watkins, Chicago, Illinois, of counsel, for plaintiff.

Robert J. Valihura, Jr., Esquire, and Mark A. Morton, Esquire, of Duane Morris & Heckscher, L.L.P., Wilmington, Delaware; and Thomas A. Reed, Esquire, of Palomar Medical Technologies, Inc., of counsel, Lexington, Massachusetts, for defendants.

JACOBS, *Vice-Chancellor*

Pending is the plaintiff's motion for an award of attorneys' fees and expenses. The plaintiff, as Trustee for the Pamela H. Siegman Trust, holds 2000 shares of common stock of Palomar Medical Technologies, Inc. ("Palomar"). The defendants, who are Palomar and its directors, oppose the application. The issue is whether, in the circumstances of this case, the plaintiff is entitled to an award of reasonable attorneys' fees and expenses, despite having lost the case on the merits. For the reasons discussed below, the Court determines that plaintiff is entitled to an attorneys' fee award, but for less than the amount requested.

I. FACTS

On August 27, 1997, the plaintiff brought this action challenging the validity of ten separately issued series of Palomar preferred stock, and of the common stock into which certain series of the preferred had been converted (collectively, the "series preferred"). The basis for the plaintiff's claim was that the series preferred was void, because Palomar's certificate of incorporation did not expressly authorize the issuance of stock in series as the Delaware General Corporation Law required. On September 31, 1997, the defendants agreed to a standstill order that prohibited Palomar from issuing any additional preferred stock, pendente lite. Following an expedited trial, this Court handed down a Memorandum Opinion dated March 9, 1998

("Opinion"), holding that (i) the series preferred stock was unauthorized and therefore invalid at the time it originally was issued, but (ii) the Certificates of Correction that Palomar filed after this action was commenced, cured the invalidity of, and retroactively validated, the series preferred stock.[1]

By way of background, in various board resolutions adopted between October 30, 1995 and March 26, 1997, Palomar's board of directors authorized and issued ten separate series of convertible preferred stock. Those stock issuances were significant to Palomar: the capital generated from their sale to investors totaled $50 million.[2] In connection with each preferred stock issuance, Palomar obtained legal opinions, some from non-Delaware law firms and others from Palomar's general counsel, stating that in counsel's opinion, Palomar's certificate of incorporation authorized the company's board of directors to issue each of the series of preferred stock. Those opinions were publicly disclosed by Palomar in various documents filed with the United States Securities and Exchange Commission ("SEC").

The complaint averred that none of the ten series of preferred stock was validly issued, because Palomar's certificate of incorporation did not expressly authorize Palomar's Board to issue preferred stock in series as Delaware's corporation statute[3] required. On September 23, 1997, two months after this action was commenced and one week after the plaintiff's pretrial opening brief was filed, Palomar filed Certificates of Correction with the Delaware Secretary of State under 8 Del. C. §103(f). The Certificates of Correction added the language "series of such," where appropriate, in the "blank-check" provision of Palomar's certificate of incorporation,[4] in order to supply the previously (and inadvertently) omitted authorization for Palomar's board of directors to issue preferred stock in series.

Despite the filing of the Certificates of Correction, the plaintiff continued to press her claim that the series preferred were invalid. She argued that the Certificates of Correction did not cure the original invalid issuances of the series preferred, because under 8 Del. C. §103(f), the Certificates could not operate retroactively as against any common stockholders who would be "adversely affected" by the correction. The plaintiff claimed that all common stockholders would be adversely affected by a retroactive validation of the series preferred, because the common stock

---

[1]Siegman v. Palomar Medical Technologies Inc., Del. Ch., C.A. No. 15894, Jacobs, V.C. (March 9, 1998).

[2]Palomar issued a total of 50,000 shares of preferred stock at a price of $1,000 per share.

[3]See, 8 Del. C. §§102(a)(4) and 151.

[4]The Restated Certificate of Incorporation of Palomar, Article 4, relevantly stated that "additional designations and powers, the rights and preferences and the qualifications, limitations or restrictions with respect to each class of stock of the corporation shall be as determined by the Board of Directors from time to time."

would be further diluted when the preferred became converted into common stock.

In its Opinion, this Court accepted the plaintiff's position that the series preferred were invalid at the time of their original issuance. The Court rejected, however, plaintiff's argument that the invalidity could not be cured by the Certificates of Correction, and ruled that the filing of those Certificates did operate retroactively to cure the original invalidity. Therefore, the Court granted judgment in favor of the defendants and against the plaintiff.

II. THE PARTIES' CONTENTIONS

The plaintiff contends that even though she did not prevail on the ultimate merits, she is entitled to an award of attorneys' fees because: (i) her claim was meritorious when filed, (ii) the prosecution of the action caused the defendants to correct the invalidity complained of, and (iii) the defendants' actions conferred substantial and important benefits upon Palomar and its stockholders that justify a $550,000 fee, plus expenses.

The defendants argue that the plaintiff is not entitled to attorneys' fees and expenses, because (i) under the American Rule the plaintiff must bear her own litigation expenses, particularly where she is not the prevailing party,[5] (ii) no equitable or statutory exception to the American Rule justifies Palomar having to pay the plaintiff's attorneys' fees and expenses in this case, and (iii) even if a fee is awardable, the $550,000 amount requested is grossly excessive.

III. ANALYSIS

These contentions frame three basic issues: (i) is the plaintiff judicially estopped from claiming any fee, (ii) if not, does the plaintiff's fee claim come within an exception to the American Rule and (iii) if so, what is a reasonable fee award in the circumstances of this case?

The problem presented here is best illustrated if it is supposed that at the time the Certificates of Correction were filed, the plaintiff ceased prosecuting this litigation and simply declared victory. Had that occurred, the plaintiff would have been entitled to an award of attorneys' fees for having caused the board to cure the absence of authority to issue the series preferred. Here, however, the plaintiff continued to prosecute the litigation,

---

[5]See Tandycrafts, Inc. v. Initio Partners, Del. Supr., 562 A.2d 1162 (1989) ("The starting principle is recognition of the so-called American Rule, under which a prevailing party is responsible for the payment of his own counsel fees in the absence of statutory authority or contractual undertaking to the contrary.").

albeit unsuccessfully, to a conclusion. That factual twist raises a novel question, namely, whether a plaintiff who continues litigating after the defendants take action that arguably renders her claim moot,[6] and then loses the case on the merits, is entitled to an award of attorneys' fees for the attorney time and effort expended throughout the entire litigation. For the reasons next discussed, the Court concludes that the plaintiff has created a benefit that entitles her to an award of attorneys' fees and expenses, but only for services rendered up to and until the time the benefit was created.

A. Judicial Estoppel

[1] I first address the threshold defense that the doctrine of judicial estoppel bars the plaintiff from contending that she created a fee-compensable benefit at all. The plaintiff claims credit for having caused the retroactive validation of the series preferred, arguing that this lawsuit induced the defendants to file Certificates of Correction while the litigation was pending. The defendants contend that the plaintiff should not be entitled to claim credit for that benefit, because she argued (unsuccessfully) throughout the litigation that the Certificates of Correction did not materially cure the original lack of board authority to issue preferred stock in series. The reason, plaintiff urged, was that the correction could not operate retroactively as against the common stockholders. Under the doctrine of judicial estoppel, "a party may be precluded from asserting in a legal proceeding, a position inconsistent with a position previously taken by him in the same or in an earlier legal proceeding."[7] Seeking to apply that principle to these facts, the defendants urge that because the plaintiff claimed that the Certificates of Correction were legally ineffective, which forced the defendants to incur the cost and risk of litigating that claim, the plaintiff cannot now be heard to contend the opposite, viz., that the curative effect of the Certificates of Correction was a benefit for which she may claim credit for fee-awarding purposes.

The plaintiff contends that the judicial estoppel defense is inapplicable, because that doctrine does not prevent a litigant from

---

[6]Allied Artists Pictures Corp. v. Baron, Del. Supr., 413 A.2d 876, 878 (1980) (explaining that when a case is settled or mooted, "counsel will be compensated for the beneficial results they produced, provided that the action was meritorious [when filed] and had a causal connection to the conferred benefit."). Although both sides argue this case as if the "merits" claim had been mooted by the defendants' filing of the Certificates of Correction, as a technical matter, the case was not "moot" because all claims were litigated to a conclusion. Nonetheless, both sides appear to agree that this case should be treated as a "mootness" case. For that reason, the Court has evaluated the fee application under that standard.

[7]Coates International, Ltd. v. De Mott, Del. Ch., C.A. No. 12346 at *4, Jacobs, V.C., (Feb. 4, 1994), and cases cited therein.

advancing an argument premised upon the acceptance of a judicial ruling that the litigant earlier opposed. Rather (the plaintiff argues), judicial estoppel operates only where the litigant's present position contradicts another position that the litigant previously took and that the Court was successfully induced to adopt in a judicial ruling. In that case, the argument goes, (i) the plaintiff's contention that the Certificates of Correction did not operate retroactively was never accepted, or relied upon, by this Court, and (ii) at this juncture the plaintiff is merely accepting the Court's retroactivity ruling and proceeding to the next stage -- this fee application.

[2] The plaintiff's position is correct. Judicial estoppel prevents a litigant from advancing an argument that contradicts a position previously taken by that same litigant, and that the Court was persuaded to accept as the basis for its ruling.[8] In this case, the Court neither accepted, nor did it rely upon, the plaintiff's claim that the filing of the Certificates of Correction did not operate retroactively.

Having rejected the threshold defense, the Court now turns to the merits of the fee application itself.

* * *

B. The Merits of the Fee Application

[3] The parties agree that the applicable standard on this motion for attorneys' fees is that (i) the plaintiff's claim must have been meritorious when filed, (ii) the defendants must have taken action that was causally related to the plaintiff's claims before those claims were judicially resolved,[9] and (iii) the action taken benefited the corporation or its stockholders.[10] Each of these elements is separately treated below.

---

[8]See Solomon Bros., Inc. v. Interstate Brands Corp., Del. Ch., C.A. No. 10054, Berger, V.C. (July 12, 1991).

[9]As previously noted, the parties appear to agree that the standard to be applied on this motion is that which normally governs "mootness" cases. See n.6, supra. One element of that test is that the defendants must have taken action that was causally related to the plaintiff's claims. The defendants do not dispute that they took action causally related to the filing of this action; indeed in their Reply Brief, the defendants state that they would have corrected the certificate of incorporation if a pre-suit demand had been made. That concession, plus the filing of the Certificates of Correction, establish that in taking that corrective action, the defendants were reacting to this lawsuit.

[10]See Tandycrafts, Inc., Del. Supr., 562 A.2d at 1167.

1. The Meritorious-When-Filed Requirement

The plaintiff argues that her claim was meritorious when filed, because in its Opinion the Court ultimately found that the series preferred stock was invalidly issued, and that that invalid status continued until the defendants caused the filing of the Certificates of Correction. The defendants argue that the claim was not meritorious when filed, because under §103(f), the Certificates of Correction operated retroactively to the filing of the original certificate of incorporation -- a date that long preceded the filing of the complaint. The defendants emphasize that all that the plaintiff had to do was bring her concerns to their attention before filing this action, and that they would have responded by immediately correcting the error and obviating the need for this lawsuit.

[4-5] These arguments are unpersuasive. While deserving points for metaphysical creativity, the argument that this suit was not meritorious when filed ignores the indisputable fact that this Court has now adjudicated that at the time of their original issuance, the series preferred stock was invalid. Moreover, the self-serving argument that a prompt "demand" would have rectified the problem and obviated the need for litigation, is legally irrelevant, because 8 Del. C. §103(f) contains no "demand" requirement[11] and no basis has been shown to read that requirement into that statute. In this case the plaintiff's claim was meritorious when filed, because (i) the series preferred stock was found to be invalid ab initio, and it remained invalid until the Certificates of Correction were filed, and (ii) those Certificates were not filed until after this action was well underway.

2. The Requirement of Benefit to Palomar and Its Stockholders

[6] Of the factors normally considered in determining a reasonable fee, the benefit achieved by the litigation is normally accorded the greatest weight.[12] The issue here is whether this litigation created a benefit, and if so, what was that benefit's value. The defendants argue that the benefit must be defined in terms of the relief the plaintiff ultimately seeks, here the

---

[11] 8 Del. C. §103(f) states in relevant part: "[w]henever any instrument authorized to be filed with the Secretary of State under any provision of this title, has been so filed and is an inaccurate record of the corporate action therein referred to, or was defectively or erroneously executed, sealed or acknowledged, the instrument may be corrected by filing with the Secretary of State a certificate of correction of the instrument which shall be executed, acknowledged, filed and recorded in accordance with this section." Compare Chancery Court Rule 23.1 ("[t]he complaint shall . . . allege . . . the efforts . . . made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority.")

[12] Croyden Associates v. Tesoro Petroleum Corp., Del. Ch., C.A. No. 13162, Jacobs, V.C. (Apr. 20, 1994).

invalidation of the series preferred. Because the plaintiff never achieved that objective, it is argued, this litigation conferred no benefit at all. Alternatively, the defendants contend that even if one accepts as valid the quite different benefit upon which the plaintiff presently relies (the retroactive validation of the preferred stock), that benefit is of no cognizable value, because the Certificates of Correction created no new legal right and only corrected a ministerial error in the original certificate of incorporation. Third, the defendants argue that this litigation did not benefit Palomar, and indeed was detrimental to it, because the lawsuit created needless expense and distraction and because the standstill order prohibited Palomar from raising capital by issuing new preferred stock until the litigation was resolved.

The plaintiff responds that (a) the correction of a fundamental flaw in Palomar's equity structure was an important and substantial benefit to Palomar and its stockholders, (b) the plaintiff's litigative efforts directly caused that benefit. In addition, (c) the Certificates of Correction eliminated any risk of future liability arising out of having void securities outstanding in the marketplace, in cases involving different facts where the Certificates of Correction might not have retroactive effect.[13] Finally, the plaintiff argues that the holders of thousands of shares of preferred stock, plus the holders of over 9 million shares of common stock issued on conversion of some of the preferred stock, benefited from this litigation because they had originally acquired preferred stock they had no reason to believe was invalid. The plaintiff argues that, because the holders of that void stock received the benefit of having their stock validated retroactively, it is fair and equitable that those shareholders be required to share in the litigation costs incurred to obtain that benefit.

[7-8] I am fully satisfied that this lawsuit conferred a significant benefit upon Palomar and its stockholders, because it induced the defendants to file the Certificates of Correction. This Court has recognized, although in a somewhat different context, that the correction of improper disclosures in a tender offer disclosure document is a fee-compensable benefit, because "[w]here a representative shareholder succeeds in correcting invalid disclosures in connection with a transaction . . . our case law recognizes that for fee awarding purposes, the corporation and all of its shareholders are benefited."[14] The Certificates of Correction created an analogous benefit

---

[13]For example, other persons to whom false warranties concerning the validity of the preferred stock were made could have been substantially and adversely affected by a retroactive correction. See 8 Del. C. §103(f).

[14]Eisenberg v. Chicago-Milwaukee Corp., Del. Ch., C.A. No. 9374 *3, Jacobs, V.C. (Oct. 25, 1988) summarily aff'd in Chicago-Milwaukee Corp. v. Eisenberg, Del. Supr., No. 469, Moore, J. (Feb. 23, 1989) (Order) (plaintiff found entitled to an award of attorneys' fees and

here, by furnishing the corporation and its shareholders reliable information about the validity of their series preferred stock, and, equally important, by substantively validating the series preferred in conformity with the Company's representations to the SEC and its preferred stock investors. The validation of those securities, and the avoidance of costly securities litigation and of the resulting potential damage liability if the series preferred had not been validated, was a substantial compensable benefit to Palomar and its shareholders.

3. The Reasonableness of the Amount Requested

[9] Because the plaintiff has satisfied all three prongs of the test for an award of attorneys' fees and expenses, the final issue concerns the reasonableness of the amount requested. Plaintiff seeks a fee of $550,000, plus out-of-pocket expenses of $9,726.71. All parties agree that the appropriate basis for determining a reasonable fee amount is quantum meruit. In performing that analysis, the Court must take into account (1) the time and effort expended by the plaintiff's counsel, (2) the complexity and difficulty of the case, (3) whether the representation was contingent in nature,[15] (4) the standing and ability of plaintiff's counsel, [16]and (5) the benefit conferred.[17] The relevant analysis appears below.

a. The Time and Effort of Plaintiff's Counsel

The defendants first argue that the 174.2 hours expended by plaintiff's counsel up to the filing of the Certificates of Correction was excessive, because a simple pre-suit demand could have avoided the litigation in its

---

expenses where the lawsuit led to a preliminary injunction and order that caused the defendants to make a correction that resulted in "a tender offer based on corrected disclosures and free of coercive elements.").

[15]It is undisputed that because this litigation was undertaken entirely on a contingency basis, it involved significant risk to counsel.

[16]It is also undisputed, and the Court is aware, that both Prickett, Jones, Elliott, Kristol & Schnee and Susman & Watkins are highly respected firms with significant experience in shareholder litigation. The plaintiff claims that because the behavior of Palomar's spokesman after the Opinion was issued (describing the action as a "strike suit") subjected counsel to the additional risk of losing clients, the Court should take Palomar's conduct, and its possible effect on plaintiff's counsel, into account in determining what constitutes a reasonable fee. The defendants respond (and I agree) that this argument only serves to distract the Court from the issue at hand. If plaintiff's counsel believes they have been disparaged, they are free to take whatever legal action they deem appropriate, and seek compensation for any wrongful conduct, in a different forum. This forum is not the proper one to address that kind of intramural dispute.

[17]See Gelobter v. Bressler, Del. Ch., C.A. No. 7293, Jacobs, V.C. (Nov. 6, 1991); See also Sugarland Indus. v. Thomas, Del. Supr., 420 A.2d 142, 149-150 (1980); Goodrich v. E.F. Hutton Group, Inc., Del. Supr., 681 A.2d 1039, 1050 (1996).

entirety. Alternatively, the defendants urge that if the Court decides to award attorneys' fees, the only legal services that merit compensation are those that were performed up to the filing of the Certificates of Correction. The reasons, defendants claim, are that (i) only those litigative efforts brought about the curative acts found to constitute a benefit, and (ii) any time devoted thereafter to prosecuting the claim that the Certificates of Correction did not operate retroactively, should not be considered. The plaintiff responds that in order to be fair the fee must compensate her counsel for all the attorney time and effort that was required to litigate the entire case.

[10] I cannot fully agree with either side's position. Only 174.2 hours of attorney time -- expended from the preparation of the complaint up to the filing of the Certificates of Correction -- were needed to create the benefit that is the predicate for a fee award. There is no showing that those 174.2 hours were excessive; indeed, plaintiff's counsel had a duty to their client to prepare their case in the most effective way possible in the circumstances. Counsel are entitled to be compensated for the attorney time and effort required to bring about the benefit. What counsel are not entitled to is compensation for their subsequent litigative efforts that did not result in any compensable benefit.[18]

b. The Complexity of the Case

The complexity of the case is another factor that bears on the amount of the fee. Plaintiff argues that this case was complex, indeed difficult, if only because their counsel were required to discredit ten separate opinions of counsel stating that Palomar had the authority under Delaware law to issue each of the multiple series of preferred stock. The defendants respond that the only "complexity" in this case was the plaintiff's refusal to recognize that she had no chance of establishing that the certificate of incorporation contained a mistake that was incapable of correction. Defendants urge that this case would have been short and simple had the plaintiff declared victory by conceding that the Certificates of Correction rectified the error, rather than forging ahead with this litigation.

I agree that the complexity of this matter favors an award of attorneys' fees for the services rendered up to the filing of the Certificates of Correction. The plaintiff was required to, and did, satisfy the Court that the

---

[18]Even if a pre-suit demand might have avoided the need for this litigation, 8 Del. C. §103(f) does not require a pre-suit demand and this Court declines to read such a requirement into that statute.

opinions of Palomar's various attorneys -- that the series preferred had been validly issued -- were not correct.

c. The Reasonableness of the Fee in Light of the Benefit Conferred

The final question is whether the $550,000 amount being requested is reasonable. The plaintiff claims that it is, because the benefit was substantial. Although the plaintiff concedes that the benefit is not precisely quantifiable, she argues that the validation of stock transactions that generated $50 million of capital evidences that the benefit had significant monetary value, and that therefore it is fair that a quantum meruit-based fee bear a reasonable relationship to the dollar amount of the underlying transactions. Plaintiff contends that the amount requested is quite modest, because $550,000 represents only one cent ($.01) for each Palomar common share currently outstanding.

The defendants disagree. They argue that the $550,000 is unreasonably high because that amount represents $887 per hour -- far more than the hourly rates plaintiff's counsel normally command. The defendants argue that any fee should bear some reasonable relationship to the plaintiff's attorney's standard hourly rate(s), multiplied by the hours worked by each attorney up to the date the Certificates of Correction were filed.

[11] Having considered these colliding positions, I conclude that a reasonable fee is $125,000, inclusive of expenses. I do not agree that the fee should be predicated on a benefit valued at $50 million, because that amount is not a correct measure of the benefit achieved. Moreover, the $550,000 figure bears little or no relationship to the $50 million amount. The benefit, to be sure, was significant, but it was also intangible and incapable of precise quantification, at least on the present record. In the Court's opinion, an award of $125,000 is more than adequate to compensate plaintiff's counsel for taking the case on a contingency basis, with its attendant financial risks, and for performing the work that created the benefit.[19] The plaintiff's counsel are not entitled to compensation for work done thereafter which did not contribute to the benefit.

[12] The lesser fee amount being awarded here is not intended to, and should not be viewed as, a penalty for or criticism of the plaintiff's decision to prosecute to a conclusion her claims that the Certificates of Correction did not operate retroactively. Although she did not prevail on the merits of that claim, the plaintiff cannot be faulted for pressing the claim, because at that time, it was unknowable whether or not it would succeed. Having said that,

---

[19]For such relevance as it may have, $125,000 represents (after deducting out-of-pocket expenses) an hourly rate of more than $650 per hour for each attorney who worked on the case.

the Court is nonetheless constrained to conclude that attorneys' fees cannot be awarded as compensation for litigative efforts that, with the perspective of hindsight, turned out to be unsuccessful.

IV. CONCLUSION

For the reasons set forth above, the Court grants plaintiff's request for an award of reasonable attorneys' fees and concludes that a reasonable award of attorneys' fees and expenses is $125,000. IT IS SO ORDERED.

SMITH v. SMITTY MCGEE'S, INC.

No. 15,668

Court of Chancery of the State of Delaware, New Castle

May 8, 1998

Plaintiff, a shareholder of defendant Smitty McGee's Inc., instituted an action against defendant's sole director and sixty percent shareholder and its former sole director and sixty percent shareholder seeking to recover funds they allegedly misappropriated from the corporation between 1991 and 1997. The defendants moved to dismiss the complaint: (1) for failure to state a claim for breaches of the fiduciary duty of loyalty and care, aiding and abetting the breaches of fiduciary duty, unjust enrichment, common law fraud, and Racketeer Influenced and Corrupt Organizations Act (RICO) violations; and (2) for failure to plead demand futility adequately.

The court of chancery, per Vice-Chancellor Steele, granted the motion in part and dismissed the motion in part. The court held that the plaintiff adequately pled a factual basis for concluding that demand upon the sole director and sixty percent shareholder would be futile because she is arguably self-interested. As a consequence, that motion was denied. The court denied the motion with respect to the breaches of fiduciary duty, aiding and abetting, and unjust enrichment but granted the motion to dismiss the common law fraud and RICO claims.

1. Pleading ⚿ 679

On a motion to dismiss for failure to state a claim upon which relief can be granted, the court assumes the truth of all well-pleaded facts in the complaint and draws all inferences from these facts in the light most favorable to the plaintiff.

2. Pleading ⚿ 679

Mere conclusory allegations will not be accepted as true on a motion to dismiss for failure to state a claim upon which relief may be granted.

3. Pleading ⚿ 622

A complaint will be dismissed for failure to state a claim upon which relief may be granted only if it appears to a reasonable degree of certainty that the plaintiff would not be entitled to relief under any set of facts which could be proved in support of his claim.

4. Pleading ⚿ 622

A motion to dismiss a breach of fiduciary duty or waste of corporate assets by claiming that money withdrawals were legitimate loans or indemnification payments failed to satisfy defendant's burden of proving there is no set of circumstances under which the plaintiff would be entitled to relief.

5. Corporations ⚿ 312(3)

A claim for aid and abetting requires (1) a fiduciary duty relationship, (2) a breach of the fiduciary's duty, and (3) a third party's knowing participation in that breach.

6. Corporations ⚿ 312(3)

A mere conclusory statement that a third party had knowledge of a defendant's fiduciary duties and knowingly and substantially participated and assisted in a defendant's breach of that duty will not withstand a motion to dismiss under Rule 12(b)(6).

7. Corporations ⟹ 312(3)

In a claim of aiding and abetting a breach of fiduciary duty, a defendant's responsibility for writing checks on a corporate account permits the court to infer from this duty that the defendant's participation was knowing in a defendant's motion to dismiss.

8. Corporations ⟹ 331

To state a cause of action for negligence in managing corporate assets, a plaintiff must allege that the defendant breached a duty owed to the plaintiff and that the breach of duty was the proximate cause of an injury to the plaintiff.

9. Pretrial Procedure ⟹ 624

On a motion to dismiss a complaint, a court assesses only whether, assuming the truth of plaintiff's allegations, the complaint states any possible claim for relief.

10. Corporations ⟹ 314

Unjust enrichment is the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience.

11. Corporations ⟹ 312(3)

The court may impose a constructive trust over any assets traceable to defendants' fraudulent or unfair and unconscionable conduct still held by the defendant.

12. Fraud ⟹ 184.2

The elements of fraud are (1) a false representation, usually of fact, made by the defendant; (2) the defendant's knowledge or belief that the representation was false, or defendant's reckless indifference to the truth; (3) an intent to induce the plaintiff to act or refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance.

13. Fraud ⚿ 184.41

The elements of fraud must be pled with particularity, including at least the time, place, and content of the false representation, and what was obtained thereby.

14. Racketeer Influenced and Corrupt Organizations ⚿ 56

A plaintiff shareholder must prove a direct injury distinct from acts which caused injury to the corporation in order to have standing to bring an individual RICO claim.

15. Racketeer Influenced and Corrupt Organizations ⚿ 56

The purchase by a defendant of additional shares in a corporation without directly decreasing a plaintiff's minority interest does not create a direct injury sufficient to allow the plaintiff standing to pursue a cause of action under RICO.

16. Racketeer influenced and Corrupt Organizations ⚿ 319.15

Any claim under RICO subsection 1962(d) making it unlawful for any person to conspire to violate other subsections of section 1962 necessarily must fail where substantive claims themselves were deficient.

17. Corporations ⚿ 206.4

In shareholder derivative suit in which board that would be considering shareholder demand did not take the challenged actions, a court must determine whether or not particularized factual allegations of derivative shareholder complaint creates a reasonable doubt that, as of the time complaint is filed, board of directors could have properly exercised its independent and disinterested business judgment in responding to demand; if derivative plaintiff satisfies burden, demand will be excused as futile.

18. Corporations ⚿ 314.5

Directorial interest exists where corporate decision will have material detrimental impact on director, but not on corporation and stockholders.

19. Corporations ⟹ 314.4

In a court of equity, recipients of property who may be free of wrongdoing, may be ordered to make restitution to the plaintiff for any assets obtained by another's wrongdoing and transferred to the recipient.

20. Pleading ⟹ 239.5

A plaintiff's motion to amend will be freely granted unless the defendant can prove that allowing the amendment would be prejudicial.

21. Pleading ⟹ 251

A motion to amend must be denied if, after assuming the truth of plaintiff's allegations, plaintiff has failed to state a claim upon which relief may be granted.

22. Corporations ⟹ 152

Generally, whether or not a corporation should declare a dividend rests within the sound discretion of the board of directors, and the decision is protected by the business judgment rule.

Ben T. Castle, Esquire, and Matthew P. Denn, Esquire, of Young, Conaway, Stargatt & Taylor, Wilmington, Delaware, for plaintiff.

S. Bernard Ableman, Esquire, and David L. Finger, Esquire, of Biggs and Battaglia, Wilmington, Delaware, for defendant Smitty McGee's, Inc.

Gary W. Aber, Esquire, of Heiman Aber & Goldlust, Wilmington, Delaware, for defendant Ronald "Rick" McGee.

F.L. Peter Stone, Esquire, of Trzuskowski Kipp Kelleher & Pearce, Wilmington, Delaware, for defendant Dawn McGee.

STEELE, *Vice-Chancellor*

Plaintiff, a shareholder of nominal defendant Smitty McGee's, Inc. ("SMI"), instituted this action against SMI's sole director and 60% shareholder and its former sole director and 60% shareholder seeking, primarily, to recover funds they allegedly misappropriated from SMI between 1991 and 1997. Defendants' move to dismiss the complaint:

(a) for failure to state a claim for breaches of the fiduciary duty of loyalty and care, aiding and abetting the breaches of fiduciary duty, unjust enrichment, common law fraud and Racketeer Influenced and Corrupt Organizations Act ("RICO") violations; and

(b) for failure to plead demand futility adequately.

I deny the motion to dismiss in part and grant the motion in part.

Plaintiff adequately plead a factual basis for concluding demand upon the sole director and 60% shareholder would be futile because she is arguably self-interested. As a consequence, the motion directed to that issue is denied.

I deny the motion with respect to the breaches of fiduciary duty, aiding and abetting, and unjust enrichment claims but grant the motion to dismiss the common law fraud and RICO claims.

Plaintiff s motion to amend the complaint seeks to add a claim which could not be successfully pursued. It is denied on the ground of "futility."

BACKGROUND

Plaintiff Ralph Smith instituted this action against Ronald "Rick" McGee, his former wife Dawn McGee[1], and nominal defendant SMI alleging *inter alia* that Rick McGee, with Dawn McGee's help, misappropriated SMI's funds. SMI is a Delaware corporation that owns Smitty McGee's, a restaurant in Fenwick Island. SMI's original shareholders were Plaintiff, who owned 40%, Rick McGee, who owned 40%, and Alvah Price, who owned 20%. In 1991, Rick McGee purchased Price's 20% interest to become 60% majority owner of SMI. Plaintiff continues to own the remaining 40% of SMI's shares.

Rick and Dawn McGee divorced on July 13, 1995, and pursuant to a property settlement,[2] Dawn McGee acceded to all of Rick McGee's interest in SMI. Today, SMI's shareholders are Dawn McGee, who owns 60%, and Plaintiff, who owns 40%. Rick McGee was the sole director of SMI until February 23, 1997, when he resigned and appointed Dawn McGee as sole director pursuant to 8 *Del. C.* § 228.

---

[1]Dawn McGee, now divorced from Rick McGee, expressed some displeasure at continuing to be referred to by her married surname. As I have been unable to discern her desired name from the evidence in the record, however, I continue to use the surname McGee, as it is of record until a substitution is put forward.

[2]The property settlement is now final, having been approved by the Family and Bankruptcy Courts.

Smitty McGee's restaurant opened in June of 1989. Rick McGee had primary responsibility for running the restaurant. Dawn McGee has been the manager of Smitty McGee's restaurant since 1991. Dawn McGee's responsibilities as manager included writing checks drawn on SMI's checking account.

CONTENTIONS OF THE PARTIES

A. Plaintiffs Contentions

On April 18, 1997, Plaintiff filed a Verified Complaint that alleges, broadly, that beginning no later than 1991, Rick McGee began misappropriating corporate profits from SMI[3] for personal use and to support his other businesses, including Libby's, another restaurant in Fenwick Island. Plaintiff also alleges that Dawn McGee, then the manager of Smitty McGee's, knowingly facilitated the misappropriation by writing checks and making wire transfers. The specific Counts of the complaint are as follows: Counts I, III, and V allege, respectively, that Rick McGee breached his fiduciary duty to SMI, was unjustly enriched and committed fraud. Counts VII through IX allege that Rick McGee committed several RICO violations. Counts II, IV and XI allege, respectively, that Dawn McGee negligently mismanaged SMI, was unjustly enriched and aided and abetted Rick McGee's breach of fiduciary duty. Count X alleges that Rick and Dawn McGee conspired to violate RICO.[4] On June 5, 1997, Plaintiff filed a motion to amend the complaint, seeking to add a twelfth count against SMI and its directors for failure to declare a dividend.

B. Defendants' Contentions

Defendants filed a motion to dismiss the complaint pursuant to Court of Chancery Rules 12(b)(6) and 23.1.[5] They argue that the entire complaint must be dismissed because plaintiff failed to allege demand futility and, in

---

[3]In alleging his claims for waste and theft, plaintiff refers to SMI and Smitty McGee's restaurant interchangeably. For ease of reference, I shall refer to both SMI and Smitty McGee's restaurant as SMI.

[4]Plaintiff voluntarily dismissed Count VI, alleging conversion, as to Dawn McGee. I dismissed without prejudice the remainder of Count VI, alleging conversion against Rick McGee, at oral argument.

[5]Defendant Dawn McGee moved, in the alternative, for summary judgment on the claims against her. Her motion is discussed in greater detail below. She also moved to dismiss the complaint under Court of Chancery Rules 12(b)(1), (b)(2) and (b)(5). She voluntarily dismissed the motion under (b)(1) at oral argument, and her motions pursuant to (b)(2) and (b)(5) have apparently also been abandoned.

addition, that each of the eleven counts of the complaint fails to state a claim upon which relief may be granted. Defendants also oppose plaintiff's motion to amend the complaint to add a twelfth count for failure to declare a dividend on the grounds that if amended as plaintiff requests, the complaint will not state a claim upon which relief may be granted and will be subject to dismissal under Rule 12(b)(6).

MOTION TO DISMISS FOR FAILURE TO STATE A CLAIM[6]

[1-3] On a motion to dismiss for failure to state a claim upon which relief may be granted, this Court assumes the truth of all well-pleaded facts in the complaint and draws all inferences from those facts in the light most favorable to the plaintiff.[7] Mere conclusory allegations, however, will not be accepted as true.[8] A complaint will be dismissed only if "it appears to a reasonable degree of certainty the plaintiff would not be entitled to relief under any set of facts which could be proved in support of his claim."[9]

A. Breach of Fiduciary Duty Against Rick McGee

Count I of the complaint alleges that Rick McGee misappropriated funds from SMI's bank accounts on several occasions, for his personal use or to sustain his other businesses. With respect to the allegation that Rick McGee used SMI's funds to support his other businesses, the complaint states that he: (1) "used profits from Smitty McGee's to pay suppliers for food that was used by Libby's restaurant," (2) "used Smitty McGee's corporate funds to make payments on a $540,000 personal loan from Baltimore Trust Bank which he had taken out to support Libby's," (3) "used Smitty McGee's funds to pay the Baltimore Trust Bank for a loan that Baltimore Trust made to Double Feature Video, another one of . . . Rick McGee's businesses" and (4) "transferred Smitty McGee's funds directly to Libby's under the false pretense that such fund transfers were being used for food purchase or preparation."[10] Plaintiff alleges that this "theft of . . . corporate funds to pay for expenses and debts at [Rick McGee's] other

---

[6]I discuss the motion to dismiss for failure to plead demand futility later in this Opinion. Demand futility need only be discussed with regard to any derivative claims that survive the motion to dismiss for failure to state a claim upon which relief may be granted.

[7]*James River-Pennington, Inc., v. CRSS Capital, Inc.*, Del. Ch., C.A. No. 13870, slip op. at 9-10, Steele, V.C. (Mar. 6, 1995)(citing *Hart Holding v. Drexel Burnham Lambert*, Del. Ch., 593 A.2d 535, 538 (1991) and *Grobow v. Perot*, Del. Supr., 539 A.2d 180, 187 n.6 (1988)).

[8]*Id.* at 10.

[9]*Id.* (citing *Rabkin v. Philip A. Hunt Chem. Corp.*, Del. Supr., 498 A.2d 1099, 1104 (1985) and *In re USACafes, L.P. Litig.*, Del. Ch., 600 A.2d 43, 47 (1991)).

[10]Compl. ¶ 13(a)-(d).

businesses constituted a breach of his fiduciary duties to [SMI] and its shareholders, and a waste of corporate assets."[11]

With respect to the allegation that Rick McGee misappropriated SMI's funds for his personal use, the Complaint alleges that he: (1) "used profits from [SMI] to make payments on loans for his mother's home and rental properties he owned with defendant Dawn McGee," (2) "made so-called 'loans' to himself from [SMI's] profits, which have never been repaid and for which no proper accounting has been made. . . ." (3) "used [SMI's] funds to make payments on a $100,000 personal loan from the Baltimore Trust Bank" and (4) "used [SMI's] corporate funds to pay for legal costs associated with a criminal investigation into his theft of [SMI's] funds, in spite of the absence of any corporate bylaw provision that would permit him to appropriate funds for this purpose."[12] Plaintiff alleges that this "misappropriation of corporate funds for personal use constitutes a breach of his fiduciary duties to the corporation and a waste of corporate assets."[13]

Plaintiff treats separately, for reasons that will become clear later in this Opinion, the following, additional allegation that Rick McGee misappropriated SMI's funds for personal use. Plaintiff alleges that Rick McGee acquired the funds to purchase Alvah Price's 20% interest in SMI, in 1991 and 1992, by "(a) borrowing money in a manner that violated federal law, (b) transferring money from [SMI's] to Libby's for no consideration, which he then withdrew from Libby's in the form of cash, and (c) writing a check to cash from the checking account of [SMI]."[14] Plaintiff also alleges that Rick McGee used SMI funds to pay the legal fees associated with the stock purchase. Plaintiff contends that this "use of corporate funds to purchase stock in the corporation for himself was a violation of his fiduciary duties and a waste of corporate assets."[15]

Rick McGee does not specifically deny any of the foregoing allegations; in fact, he admits to having made withdrawals from SMI's accounts. He contends that Count I must be dismissed for failure to state a claim, however, because each withdrawal of money was justified. Rick McGee states that every withdrawal was a legitimate loan or an indemnification payment from the corporation to himself, as specifically authorized by 8 *Del. C.* §§ 143 and 145.

[4] Each of plaintiffs allegations, if true, might represent a breach of fiduciary duty or waste of corporate assets by Rick McGee. At trial, of course, plaintiff will have to overcome any evidence tending to show that the

---

[11]Compl. ¶ 14.
[12]Compl. ¶ 19-22.
[13]Compl. ¶ 23.
[14]Compl. ¶ 16.
[15]Compl. ¶ 18.

withdrawals were proper loans or indemnification payments, but on a motion to dismiss, the burden is defendants'. They have failed to prove that there is no set of circumstances under which plaintiff would be entitled to relief.[16] The motion to dismiss Count I is denied.

B. Aiding and Abetting Claim Against Dawn McGee

Count XI of the complaint alleges that "Defendant Dawn McGee was a knowing participant in Mr. McGee's breaches of his fiduciary duties, in that she transported and transferred funds and wrote checks associated with those fiduciary breaches."[17] Dawn McGee moved to dismiss this claim against her, arguing that she merely followed her husband's orders when she facilitated his withdrawals and that, if the withdrawals were not proper, she had no knowledge and should not be held responsible.

[5-6] A claim for aiding and abetting requires: (1) a fiduciary relationship, (2) a breach of the fiduciary's duty and (3) a third party's knowing participation in that breach.[18] A mere conclusory statement that a third party "had knowledge of [a defendant's] fiduciary duties and knowingly and substantially participated and assisted" in the defendant's breach of that duty, will not withstand a motion to dismiss under 12(b)(6).[19]

[7] Plaintiff has alleged sufficient facts that, if true, would satisfy the first two elements of a claim for aiding and abetting. Plaintiff also alleges that Dawn McGee knowingly participated in Rick McGee's alleged breaches of fiduciary duty. Because plaintiff alleges that Dawn McGee was the manager of Smitty McGee's restaurant and that, as manager, she had "partial and ultimately full responsibility for writing checks drawn on [SMI's] checking account,"[20] the Court may infer from her duties that her participation was knowing.[21] Plaintiff may ultimately fail to prove knowing participation by a preponderance of the evidence at trial, but accepting the truth of all well-pleaded allegations of the complaint and construing all inferences to be drawn from those facts in the light most favorable to plaintiff, I cannot now say that there is no set of circumstances under which plaintiff would be entitled to relief.

---

[16] *See Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.*, Del. Ch., C.A. No. 13950, 1995 WL 6943 97 at *15, Allen, C. (Nov. 21, 1995).

[17] Compl. ¶ 69.

[18] *In re Santa Fe Pacific Corp. Shareholder Litigation*, Del. Supr., 669 A.2d 59, 72 (1995).

[19] *Id.*

[20] Compl. ¶ 26.

[21] *Carlton Investments*, Del. Ch., C.A. No. 13950, 1995 WL 694397 at *16, Allen, C. (Nov. 21, 1995).

C. Negligent Management Against Dawn McGee

[8] Count II alleges that "Dawn McGee negligently managed the corporation's assets, in that she violated the standard of care required in her management position, and in so doing caused damage to the corporation."[22] To state a cause of action for negligence in Delaware a plaintiff must allege that the defendant breached a duty owed to the plaintiff and that the breach of duty was the proximate cause of an injury to the plaintiff.[23]

Plaintiff alleges that Dawn McGee, as the manager of SMI with responsibility for writing checks drawn on its checking account, owed the corporation and the restaurant a legal duty of reasonable care. Plaintiff further alleges that she breached that duty by participating in Rick McGee's illegal misappropriation of SMI's funds, knowing that the challenged transactions were illegal. Finally, plaintiff alleges that Dawn McGee's facilitation of Rick McGee's theft and/or waste of SMI's assets caused SMI to be injured.

[9] Defendants contend that count II should be dismissed because Dawn McGee owed no duty to the corporation or the restaurant, Rick McGee's withdrawals of money were not illegal, Dawn McGee did not know that Rick McGee's withdrawals of money were illegal, and plaintiff has not proved that "but for" Dawn McGee's participation, Rick McGee would not have completed the transactions on his own. Each of defendants' arguments in this regard, however, faults plaintiff for not proving his entire claim in his complaint. Plaintiff must face the burden of proving his claims at the upcoming trial on the merits. On a motion to dismiss, however, I assess only whether, assuming the truth of plaintiffs allegations, the complaint states *any possible* claim for relief.[24] I find that count II satisfies this standard, and I therefore deny defendants' motion to dismiss count II, one which I construe to be for breach of the fiduciary duty of care.

D. Unjust Enrichment Against Rick and Dawn McGee

Counts III and IV allege that Dawn and Rick McGee, respectively, "personally benefitted from Mr. McGee's violations of his fiduciary duties, and continue[] to benefit from those violations. . . ."[25] Specifically, the

---

[22]Compl. ¶ 30.

[23]*Croom v. Pressley*, Del. Super., C.A. No. 93C-01-026, Ridgely, J. (July 29,1994).

[24]*Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 140 (1997) ("[A] motion to dismiss, at such a preliminary stage, requires the court to determine with 'reasonable certainty' that a plaintiff could prevail on no set of facts that can be inferred from the pleadings.")(quoting *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 38 (1996)).

[25]Compl. ¶¶ 33, 35.

complaint states that Rick and Dawn McGee transferred money from SMI's accounts into their joint bank account, used money from SMI's accounts to purchase and maintain several pieces of real property and businesses, and used money from SMI's accounts to purchase Price's shares in the corporation. Defendants moved to dismiss the unjust enrichment counts on the basis that plaintiff is seeking inappropriate remedies against Rick and Dawn McGee, namely, the imposition of a constructive trust.

[10-11] "Unjust enrichment has been defined as 'the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience.'"[26] Plaintiff has alleged facts that, if true, show that Rick and Dawn McGee are unjustly retaining benefits, money and property that they would not otherwise have if not for the preceding withdrawals of money from SMI. If plaintiff's allegations are true, the retention is both a loss to SMI and "against the fundamental principles of justice or equity and good conscience." If the unjust enrichment is the result of defendants' fraudulent or unfair and unconscionable conduct, this Court may impose a constructive trust over any assets traceable to that conduct and still held by defendants.[27] The claims made out in the pleadings show should Dawn McGee not be found to have participated in any wrongdoing, it may not be appropriate to impose a constructive trust on assets that have been transferred to her. Nevertheless, I may order her to make restitution to plaintiff.[28]

E. Fraud Against Rick McGee

Count V states that "plaintiff relied upon and was damaged by"[29]

> "multiple knowingly false statements and material omissions made by defendant Rick McGee to the plaintiff which misled the plaintiff. Specifically, defendant Rick McGee repeatedly told Mr. Smith that the store was unable to pay Mr. Smith dividends because it was not making sufficient profits, when in fact Mr. McGee was siphoning off the corporation's profits through sham loans, sham reimbursement payments, and direct cash withdrawals."[30]

---

[26]*Nash v. Schock*, Del. Ch., C.A. No. 14721, 1997 WL 770706 at *6, Steele, V.C. (Dec. 3, 1997)(quoting *Fleer Corp. v. Topps Chewing Gum, Inc.*, Del. Supr., 539 A.2d 1060, 1062 (1988)).

[27]*Id.*

[28]*Nash*, Del. Ch., C.A. No. 14721, 1997 WL 770706 at *7, Steele, V.C. (Dec. 3, 1997).

[29]Compl. ¶ 39.

[30]Compl. ¶ 38.

Defendants contend that count V must be dismissed because it fails to plead fraud with particularity as required by Rule 9(b). Plaintiff responded to defendants' motion to dismiss by stating only that the complaint sufficiently alleges "that Mr. McGee made material misstatements or omissions *to the corporation*, which the corporation relied upon and from which *the corporation* was damaged."[31] The allegations of count V, however, clearly attempt to state an individual claim of fraud on plaintiff's behalf and not a derivative claim on SMI's behalf.

[12-13] The elements of fraud are (1) a false representation, usually of fact, made by the defendant; (2) the defendant's knowledge or belief that the representation was false, or defendant's reckless indifference to the truth; (3) an intent to induce the plaintiff to act or refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance.[32] The elements of fraud must be pled with particularity, which has been construed to mean that the allegations include at least "'the time, place and contents of the false representations . . . and what [was] obtained thereby.'"[33]

The individual claim of fraud against Rick McGee must be dismissed because the elements of fraud have not been particularly pled. One obvious defect in plaintiff's allegation is the statement that he "relied upon" Rick McGee's statement. This conclusory statement is insufficient; to plead reliance with particularity, plaintiff must explain what he did, or refrained from doing, in justifiable reliance upon the statement. Plaintiff also failed to allege that Rick McGee intended to induce plaintiff to act or refrain from acting in reliance on the statement. In addition, plaintiff says he "was damaged" by the statement. This is another conclusory statement which is insufficient as a matter of law. Plaintiff must explain exactly what damage was caused by his action or inaction. "Time" is not pled at all, unless the Court looks elsewhere in the complaint to see that the actions alleged to constitute a breach of fiduciary duty under count I began "no later than 1991." In any event, "no later than 1991" does not constitute particularity for the purpose of a fraud action. Finally, there is no allegation of place. Defendants' additional concerns about the adequacy of the pleading need not be addressed here because the allegation is clearly deficient on its face. Defendants' motion to dismiss count V is granted.

---

[31]P.'s Ans. Br. at 13 (emphasis added).

[32]*Gaffin v. Teledyne, Inc.*, Del. Supr., 611 A.2d 467, 472 (1992).

[33]*Nutt v. A.C.& S, Inc.*, 466 A.2d 18, 23 (1983); *Browne v. Robb*, 583 A.2d 949, 956 (1990).

F. RICO Violations Against Rick McGee

Counts VII, VIII and IX allege that Rick McGee violated 18 *U.S.C.* § 1962(a), (b) and (c), respectively, when he used interstate wire transfers and telephone calls to misappropriate SMI's funds in violation of 18 *U.S.C.* § 1343, the federal wire fraud statute. Section 1964(c) creates a civil cause of action for RICO violations. It provides that a claim may be brought by "[a]ny person injured in his business or property by reason of a violation of section 1962 of this chapter. . . ."[34]

[14] Plaintiff does not have standing to bring these RICO actions because he cannot satisfy the injury requirement. The depletion of SMI's assets allegedly accomplished through Rick McGee's acts of wire fraud is an injury to the corporation; plaintiff is only indirectly injured by these acts. Plaintiff makes clear in his complaint and his answering brief that he is not seeking to bring a derivative RICO claim on SMI's behalf.[35] In order for plaintiff to have standing to bring an individual RICO claim, he must prove that he has been directly injured in a manner distinct from the alleged acts of wire fraud that caused injury to the corporation.[36]

The only direct injury plaintiff alleges is the impairment of his voting rights.[37] Specifically, plaintiff argues that Rick McGee impaired plaintiff's voting rights by purchasing Price's 20% interest in SMI. Before Rick McGee purchased Price's 20% interest, plaintiff and Rick McGee were equal shareholders, each owning 40% of SMI's shares. By purchasing Price's 20% interest, plaintiff explains, Rick McGee became a majority shareholder or, stated another way, he "made" plaintiff a minority shareholder. Plaintiff argues that Rick McGee impaired plaintiff's voting rights by "making" him a minority shareholder.

[15] Defendants correctly note that plaintiff's minority interest has not been reduced. He has the same 40% interest that he had before Rick McGee purchased Price's shares. Plaintiff has cited no case, and the Court has not been able to find one, suggesting that a person or entity may not purchase the majority of a corporation's outstanding shares simply because that single act without more, works some inequity on the corporation's minority shareholders.[38] Plaintiff has not been directly injured by Rick McGee's

---

[34] 18 *U.S.C.* § 1964(c).

[35] "[T]he claims on their face allege individual injury–impairment of voting rights. *** [T]he corporation is not the party asserting the RICO claims." P.'s Ans. Br. at 14. *See also* Compl. ¶¶ 51, 55, 60.

[36] *See, e.g., Jeffreys v. Exten*, D.De., 784 F. Supp. 146,158-59 (1992); *Klapper v. Commonwealth Realty Trust*, D.De., 657 F. Supp. 948, 953-54 (1987).

[37] Compl. ¶¶ 51, 55, 60; P.'s Ans. Br. at 14.

[38] For an analogous case see *Savin Business Machines Corp. v. Rapifax Corp.*, Del. Ch., C.A. No. 5331, 1978 WL 2498, Brown, V.C. (Feb. 15, 1978), where a majority shareholder's

actions because they did not directly decrease plaintiff's minority interest.[39] Accordingly, plaintiff has no standing to pursue a cause of action under RICO, and defendants' motion to dismiss counts VII through IX is granted.

G. Conspiracy to Commit RICO Violations Against Rick and Dawn McGee

[16] Count X alleges that Rick and Dawn McGee conspired to violate 18 *U.S.C.* § 1962(a),(b) and (c). This count must be dismissed because the counts alleging the underlying substantive allegations have been dismissed. "Any claim under section 1962(d) based on a conspiracy to violate the other subsections of section 1962 necessarily must fail if the substantive claims are themselves deficient."[40]

MOTION TO DISMISS FOR DEMAND FUTILITY

The derivative claims that survive defendants' motion to dismiss for failure to state a claim, and for which demand futility must be pled, are counts I, II, III, IV and XI. Plaintiffs complaint states that he did not make a demand on SMI's sole director, Dawn McGee, because demand would have been futile. Defendants contend that plaintiff has not appropriately pled demand futility.

[17] Where the board that would be considering a shareholder's demand did not take the challenged actions, "a court must determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand."[41] If plaintiff satisfies this burden, demand will be excused as futile.

[18] The factual allegations of the complaint do raise a reasonable doubt that Dawn McGee could have exercised disinterested business judgment.

---

purchase of additional authorized shares was found not to constitute a breach of fiduciary duty that would support a preliminary injunction, even where it had the effect of decreasing a minority shareholder's representation on the Board of Directors.

[39] *Cf. In re Tri-Star Pictures, Inc.*, Del. Supr., 634 A.2d 319, 330 (1993)(individual injury found where transfer of shares caused minority interest to be reduced from 43.4% to less than 20% without compensation).

[40] *See, e.g., Lightning Lube, Inc. v. Witco Corp.*, 3d Cir., 4 F.3d 1153, 1191 (1993); *Arthur v. Guerdon Indus., Inc.*, D. DE., 827 F. Supp. 273, 281 (1993)("Absent a RICO violation there cannot exist a conspiracy to violate the RICO statute. . . .").

[41] *Rales v. Blasband*, Del. Supr., 634 A.2d 927, 934 (1993).

> "Directorial interest . . . exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders. In such circumstances, a director cannot be expected to exercise his or her independent business judgment without being influenced by the adverse personal consequences resulting from the decision."[42]

In fact, Dawn McGee conceded that she is "arguably interested" with respect to the claims against her, counts II, IV and XI. As plaintiff seeks to impose a constructive trust on any assets Dawn McGee holds as a result of her wrongdoing or obtain restitution funded by those assets, it is clear that her interest is more than "arguable." She argues, however, that she is not interested with regard to the claims against Rick McGee, counts I and IV. [19] Dawn McGee argues that because her personal assets are not at risk "she would not suffer any 'adverse personal consequences' from any litigation against Rick McGee."[43] I disagree. Dawn McGee is not disinterested with respect to the claims against Rick McGee because his wrongdoing may affect Dawn McGee's ability to keep her property. In a court of equity even if Dawn McGee may be free of wrongdoing, she can be ordered to make restitution to SMI of any assets Rick McGee obtained through his wrongdoing and then transferred to her.[44] Although Rick McGee has agreed to indemnify Dawn McGee and to renegotiate their property settlement if she is found liable in this action, the re-opening of an otherwise final property division is, itself, potentially disadvantageous if not materially adverse to Dawn McGee but not to SMI and its stockholders.

The motion to dismiss for failure to plead demand futility is denied.

MOTION TO AMEND

On June 5, 1997, plaintiff moved to amend the complaint to add a twelfth count against Rick and Dawn McGee for failure to declare a dividend in 1996.[45] Court of Chancery Rule 15(a) states: "A party may

---

[42]*Id.* at 936.

[43]Defs.' Open. Br. at 22.

[44]*Nash*, Del. Ch., C.A. No. 14721, 1997 WL 770706 at *7, Steele, V.C. (Dec. 3 1997)(ordering recipients of property, who were not themselves guilty of wrongdoing, to make restitution to plaintiff, because "it would be contrary to the principles of equity and good conscience to permit them to retain any assets that would have benefitted plaintiff had it not been for [defendant's] antecedent breach of fiduciary duty").

[45]The complaint actually does not state for which year a dividend is sought, but because count XII makes reference to SMI's 1996 federal tax return, I shall infer that, *at best*, plaintiff has requested that a dividend be compelled for 1996. The year for which relief is requested, however,

amend the party's pleading once as a matter of course at any time before a responsive pleading is served. . . ." Because defendants have not yet filed an Answer, plaintiff did not have to seek leave of court to amend the complaint; but since he has, I shall decide the motion. Defendants, citing ***Bokat v. Getty Oil Co.***,[46] argue that plaintiff has waived his right to amend as a matter of course by requesting permission to amend from the Court. The ***Bokat*** court, however, based its decision that plaintiff had waived her right to amend as a matter of course on the "extraordinary combination of circumstances" present in that case.[47] I have been unable to find any additional authority in support of defendants' contention.

[20-21] A plaintiff's motion to amend will be freely granted unless the defendant can prove that allowing the amendment would be prejudicial.[48] Defendants' have not challenged plaintiff's motion as prejudicial. "[T]he proposed amended complaint[, however, must be] subjected to the same standard as a motion to dismiss."[49] The motion to amend must be denied if, after assuming the truth of plaintiff's allegations, plaintiff has failed to state a claim upon which relief may be granted. I find that plaintiff has failed to state a claim upon which relief may be granted, and I therefore deny his motion to amend.

[22] Generally, whether or not a corporation should declare a dividend rests within the sound discretion of the board of directors, and the decision is protected by the business judgment rule.[50] A plaintiff may allege wrongdoing against the board of directors, however, that causes them to lose the protection of the business judgment rule. A court may compel a corporation to pay a dividend where "the corporation's affairs are in a condition justifying the declaration of the dividend as a matter of prudent business management and that the withholding of it is explicable only on the theory of an oppressive or fraudulent abuse of discretion."[51]

---

is of little import because I find that the requested relief may not be granted in any event.

[46]Del. Supr., 262 A.2d 246 (1970).

[47]*Id.* at 252.

[48]*Paine Webber v. Centocor*, C.A. No. 14405-NC, Steele, V.C. (Jan. 15, 1997) slip op. at 7-8 (citing *Baumgart v. Penn Lyon Homes, Inc.*, Del. Supr., No. 271, 1996, Berger, J., (Apr. 23, 1996)).

[49]*Rabkin v. Hunt Chem Corp.*, Del. Ch., 480 A.2d 655, 662 (1984)("Although amendments are generally freely granted, motions to amend may be denied where, on the face of the pleading, it is clear that the amended complaint would be subject to dismissal.")(citing *Itek Corp. v. Chicago Aerial Indus., Inc.*, Del. Super., 257 A.2d 232 (1969), *rev'd on other grounds*, 498 A.2d 1099 (1985)). *See also PaineWebber*, C.A. No. 14405-NC, Steele, V.C. (Jan. 15, 1997) slip op. at 8 (citing *Moore Bus. Forms, Inc. v. Cordant Holdings, Inc.*, Del. Ch., C.A. No. 13911, 1995 WL 707877 at *3, Jacobs, V.C. (Nov. 30, 1995)).

[50]*See Treves v. Menzies*, 142 A.2d 520, 522-523 (1958); *Baron v. Allied Artists Pictures Corp.*, 337 A.2d 653, 658-59; *Gabelli & Co. v. Liggett Group, Inc.*, 444 A.2d 261, 264 (1982).

[51]*Keenan v. Eshleman*, 194 A. 40, 43 (1937) *aff'd*, 2 A.2d 904 (1938); *Baron*, 337 A.2d

Thus, if this were a typical case seeking to compel the payment of a dividend, plaintiff's complaint would allege that as of the date the action was filed, April 18, 1997, SMI had a surplus or net profits from which a dividend could readily be paid and the only reason a dividend had not yet been declared was because of Dawn McGee's oppressive or fraudulent abuse of discretion.[52] This is not what plaintiff has alleged, however, and this is not an appropriate case for the Court to compel the payment of a dividend.[53]

Plaintiff instituted this action, on SMI's behalf, to recover monies that Rick McGee, allegedly with Dawn McGee's help, allegedly misappropriated from SMI on many occasions between 1991 and 1997. If that money is recovered, money that belongs to SMI, the board of directors should have the chance to decide how it will be used.[54] The mere existence of a fund from which a dividend might be paid will not necessarily result in the declaration of a dividend: "'the holder of stock, preferred as well as common, is entitled to have a dividend declared only out of such part of them as can be applied to dividends consistently with a wise administration of a going concern.'"[55] Because I am not in a position to declare that the corporation will not need any funds recovered here for its operations, it would be inappropriate for me to order that those funds be paid out to plaintiff as a dividend. Therefore, "it appears to a certainty that under no state of facts which could be proved to support the claim asserted would . . . plaintiff be entitled to relief."[56] Futility demands plaintiff's motion to amend the complaint be denied.

DAWN MCGEE'S MOTION FOR SUMMARY JUDGMENT

Defendant Dawn McGee also moved, in the alternative, for summary judgment on the claims against her, now limited to counts II, III and XI. Plaintiff has not responded to the motion. Because it is inappropriate to consider a motion for summary judgment in the absence of at least limited

---

at 659 (quoting *Keenan*); *Moskowitz v. Bantrell*, 190 A.2d 749, 750 (1963)(same); *Treves*, 142 A.2d at 523 (same).

[52]*See supra* note 41; 8 *Del. C.* § 170.

[53]Plaintiff's allegations fall far short of the requirements. He states merely (1) that SMI's federal tax return for 1996 shows that SMI paid approximately $65,000 to Rick and/or Dawn McGee either outright or in the form of "loans" and (2) that defendants' failure to declare a dividend "in the face of large profits earned by [SMI]," and while taking money from SMI, "constituted an oppressive and gross abuse of discretion in their roles as directors." Even if plaintiff were to suggest further amendments to satisfy the pleading requirements, however, it would still be inappropriate for the Court to compel the payment of a dividend for the reasons that follow.

[54]*See supra* note 40; *Keenan*, 194 A. at 43.

[55]*Baron*, 337 A.2d at 658 (quoting *Wabash Ry. Co. v. Barclay*, 280 U.S. 197 (1930)). *See also Keenan*, 194 A. at 43.

[56]*Rubin v. Great Western Corp.*, Del. Ch., 1975 WL 1261 at *2, Brown, V.C. (Apr. 29, 1975)(citing *Shellburne, Inc. v. Conner*, Del. Ch., 296 A.2d 409 (1970)).

discovery,[57] I grant plaintiff 30 days to take discovery related to the claims against Dawn McGee. I grant plaintiff an additional 10 days to submit an answering brief in response to Dawn McGee's motion for summary judgment. Dawn McGee shall then have 5 days in which to file a reply brief.

CONCLUSION

Defendant's motion to dismiss is ***granted*** with respect to counts V and VII through X and is ***denied*** with respect to counts I through IV and XI. Plaintiff's motion to amend the complaint is ***denied.*** Decision on Dawn McGee's motion for summary judgment is stayed pending limited discovery and briefing.

IT IS SO ORDERED.

SUPERMEX TRADING CO., LTD.
v. STRATEGIC SOLUTIONS GROUP, INC.

No. 16,183

Court of Chancery of the State of Delaware, New Castle

May 1, 1998

Plaintiff filed action pursuant to a disagreement over whether or not a debenture issued by defendant, and held by plaintiff, is redeemable only for cash, as plaintiff contends, or at defendant's option, for either cash or common stock, as defendant contends. Defendant had sent plaintiff a notice of redemption which purported to redeem the debenture at the redemption amount, but payable in shares of defendant's common stock, rather than cash. Plaintiff asked the court to declare the redemption null and void, and

---

[57]*See, e.g., Vanderbilt Income and Growth Assoc. v. ARVIDA/JMB Mgrs., Inc.*, Del. Supr., No. 469, 1996, Holland, J. (Dec. 12, 1996) slip op. at 3, 14; *Levy v. Stern*, Del. Supr., No. 211, 1996 (Dec. 20, 1996)(ORDER).

also to enjoin the defendant from attempting any further redemptions of the debenture.

The court of chancery, per Vice-Chancellor Lamb, concluded that the plaintiff had in fact demonstrated that the defendant's debenture was not redeemable for shares of defendant's common stock, but redeemable for cash only. The court declared that the plaintiff was entitled to an order declaring the purported redemption invalid and restoring plaintiff's rights as holder of the debenture. However, the court declined to bar defendant from further exercise of its right to redeem the debenture for cash.

1. Contracts ☞ 147(1)

In interpreting a contract, the primary goal of the court is to satisfy the reasonable expectations of the parties at the time the contract was made.

2. Contracts ☞ 143, 151

Under the plain meaning rule of contract construction, if a contract is clear on its face, a court should rely solely on the clear literal meaning of the words.

3. Contracts ☞ 143, 151

Where parties have entered into an unambiguous integrated written contract, the contract's construction should be that which would be understood by an objective reasonable third party.

4. Contracts ☞ 154

Inquiry into the subjective unexpressed intent or understanding of the individual parties to a contract is neither necessary nor appropriate where words of the contract are sufficiently clear to prevent reasonable persons from disagreeing as to their meaning.

5. Contracts ☞ 143

Delaware courts adhere to an objective theory of contracts, requiring the court to first determine whether the contract language in dispute is ambiguous.

6. Contracts ⟹ 143(2), 147(1)
Evidence ⟹ 448, 450(5)

Only when contract language is reasonably susceptible to more than one meaning will extrinsic evidence be considered to resolve the ambiguity.

7. Contracts ⟹ 169, 175

When contractual language is reasonably susceptible to more than one meaning, overt statements and acts of the parties, the business context, prior dealings between the parties, business custom and usage in the industry will all be considered to resolve the ambiguity.

8. Contracts ⟹ 143(2), 169

While looking at background facts surrounding the contractual language of the debenture may be helpful, the court should not rely on extrinsic evidence to create an ambiguity.

9. Contracts ⟹ 151, 169

If a contract is unambiguous, extrinsic evidence may not be used to interpret the intent of the parties, to vary the terms of the contract, or to create an ambiguity.

10. Contracts ⟹ 143.5, 162

Where a contract term is prefaced by words indicating it is subject to other provisions of the contract, it means that inconsistent terms to which reference is made will trump the provision so referenced.

11. Contracts ⟹ 143(2), 159, 162

Terms of a debenture, giving a company the right to issue shares of stock in payment for principal and interest, were subliminated by terms requiring cash payment in the event of redemption where the stock payment clause was prefaced by language making it subject to the cash redemption terms.

12. Contracts ⟹ 147(1)

The subjective understandings of a party to a contract that are uncommunicated to the other party are of no effect; therefore, they are irrelevant to contract interpretation and should not be given any weight.

Elizabeth M. McGeever, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware, for plaintiff.

Jessica Zeldin, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware; and Joseph O. Click, Esquire, of Dyer, Ellis & Joseph, Washington, D.C., of counsel, for defendants.

LAMB, *Vice-Chancellor*

I. INTRODUCTION[1]

This action was filed on February 10, 1998, by the plaintiff, Supermex Trading Company, Ltd. ("Supermex"), a British Virgin Islands corporation, against the defendant, Strategic Solutions Group, Inc. ("Strategic" or the "Company"), a Delaware corporation. Trial, originally set for April 1, 1998, was conducted on April 15, 1998. The issue presented is whether or not a debenture issued by Strategic and held by Supermex is redeemable only for cash, as Supermex contends, or, at Strategic's option, for either cash or common stock, as Strategic argues.

In October of 1997, Supermex purchased a two-year 1.6 million principal amount 6% convertible subordinated debenture due October 31, 1999, issued by the defendant ("Debenture"). In conjunction with the Debenture purchase, the parties entered into among other things; (i) a Securities Purchase Agreement; (ii) a Registration Rights Agreement; and (iii) a Warrant to purchase 40,000 shares of Strategic common stock.

On January 19th, 1998, Strategic sent Supermex a notice of redemption which purported to redeem the Debenture at the Redemption Amount, as that term is defined in the Debenture, but payable in 1,052,624 shares of Strategic common stock, rather than cash.

Plaintiff asks the Court to declare the January 19th redemption null and void, and also to enjoin Strategic from attempting any further redemptions of the Debenture, as well as other assorted and related relief. For the reasons discussed below, I conclude that Supermex is entitled to an

---

[1]This opinion was delivered orally at the conclusion of closing arguments on April 23, 1998. It has been revised for distribution as a Memorandum Opinion.

order declaring the purported redemption invalid and restoring its rights as holder of the Debenture. Nevertheless, I cannot agree that Strategic is now barred from further exercise of its right to redeem for cash.

II. BACKGROUND

The background facts relevant to this decision are as follows: In the summer of 1997, Strategic was in urgent need of cash, and to this end engaged the investment firm of Corporate Capital management, Inc. for the purpose of locating an investor. With the assistance of another placement agent, the firm located Supermex, which was interested in purchasing a convertible security but, the testimony shows, as not interested in making a straight equity investment. Strategic, by contrast, would have preferred a straight equity investment or what was referred to at trial as a Rule 144 investment.

The term sheet was signed by Strategic and also by the placement agent on behalf of Supermex. The term sheet provided that Strategic would have the option of redeeming the debenture by paying cash so that the purchaser would realize the "full economic benefit" which the purchaser would have realized had it converted the debenture being redeemed into common stock and immediately sold that stock.

The terms of the Debenture are stated in it. It bears 6 percent interest per annum and matures October 30th, 1999 ("Maturity Date"). Pursuant to Section 4A thereof, Supermex, as the holder, has the right to convert in $50,000 or greater increments of principal amount into shares of Strategic common stock. The conversion price is not fixed, but fluctuates with the price of Strategic's stock. Supermex's investment was designed to allow Supermex to convert discrete portions of the debenture over a two-year period. It is structured so that Supermex would not own more than 4.99 percent of Strategic's common stock at any time during the life of the Debenture. Paragraph 2(j) of the Securities Purchase Agreement precludes Supermex from effecting a conversion of the Debenture before the Maturity Date if such conversion would cause Supermex to own more than 4.99 percent of Strategic's common stock. This limitation was designed to prevent Supermex from having to file and repeatedly amend a Schedule 13D under the Securities Exchange Act of 1934.

Under Section 4C of the Debenture, Strategic has the right to redeem all or any part of the principal amount of the Debenture. The formula for computing the amount to be paid on redemption is set forth on page 6. The Debenture there provides that Strategic may "... redeem all or any portion of the then outstanding principal amount of the Debentures . . . for an amount (the 'Redemption Amount') equal to the sum of (a) such outstanding

principle of the Debentures plus all accrued but unpaid interest thereon . . . plus (b) the Redemption Premium . . . ." Paragraph 4C(iii) also provides that Strategic's right to redeem the Debenture terminates if Strategic does not pay the Redemption Amount to Supermex within ten days of the notice of redemption.

Under Section 4C(iii) of the Debenture, Supermex has the right to avoid a redemption by electing to convert the redeemed portion of the Debenture into common stock, and by giving notice thereof to the issuer within five trading days of its receipt of the notice of redemption. Thus, to the extent Supermex chose to do so, it could forego a redemption in favor of a conversion for stock.

Paragraph 2 of the Debenture provides as follows: "Subject to the provisions of Section 4 below, the principal of, and interest on this Debenture are payable at the option of the Company, in shares of Common Stock . . . of the Company" or in cash.

Sometime after issuance of the Debenture, the Company retained another investment banking firm to assist it in making acquisitions. Because of its limited cash resources, the Company understood that any acquisition it might engage in would almost certainly be done in exchange for its common stock. The testimony is that the investment banking firm advised Strategic that the open-ended nature of the conversion feature of the Debenture made problematic any acquisition by it for stock because of the inability to predict even the maximum number of shares of common stock that would be outstanding in the event of the Debenture's full conversion. To resolve this problem, Strategic determined to redeem the Debenture and to do so for shares of its common stock, rather than for cash, in reliance on the language of paragraph 2, cited above.

Supermex refused to recognize the effectiveness of the Notice of Redemption, asserting that the Debenture required Strategic to pay cash in the case of redemptions. Rather, on January 29, 1998, acting pursuant to Section 4A of the Debenture, Supermex tendered a notice of conversion to Strategic for $115,000 principal amount of the Debenture plus $1,701 of accrued interest. Under the conversion formula found in Section 4C, Supermex was entitled to receive 90,465 shares of Strategic common stock. Strategic took no action with respect to this demand for conversion, and no shares issuable to Supermex upon that conversion have been issued.

III. DISCUSSION

[1-4] There is little controversy about the legal framework governing my consideration of this matter. First I look to the four corners of the Debenture and, applying a common sense analysis, determine whether the Debenture

is reasonably subject to more than one interpretation. In *Demetree v. Commonwealth Trust Co.*, Del. Ch., C.A. No. 14354, Allen, C., (Aug. 27, 1996), the Court made several important points about contract interpretation. First, that the "primary goal of contract interpretation is to satisfy the reasonable expectations of the parties at the time they entered into the contract," a process which "often requires a court to engage in an analysis of the intent or shared understanding of the parties' at the time of the contract. Slip Op. at 7. Second, that under the plain meaning rule of contract construction, if a contract is "clear on its face, the Court should rely solely on the clear literal meaning of the words." *Id.* And further that "Where the parties have entered into an unambiguous integrated written contract, the contracts construction should be that which would be understood by an objective reasonable third party." *Id.* Finally, that "inquiry into the subjective unexpressed intent or understanding of the individual parties [to the contract] is neither necessary nor appropriate where words of the contract are sufficiently clear to prevent reasonable persons from disagreeing as to their meaning." *Id.* at 7-8.

[5-7] To the same effect is *Bell Atlantic Meridian Systems v. Octel Communications Corp.*, Del. Ch., C. A. No. 14348, Allen, C. (Nov. 28, 1995). In that case, Chancellor Allen also stated that "the primary consideration in the construction of contract language is to fulfill, to the extent possible, the reasonable expectations of the parties at the time they contracted." *Bell Atlantic* at 12. He also stated "this is often stated as giving effect to the intent or share understanding of the parties ;. . . In this process [of discerning a shared intent], Delaware courts adhere to an 'objective' theory of contracts." *Id.* at 12-13. The Chancellor stated, further, "under the objective approach, the court must first determine whether the contractual language in dispute is ambiguous. When the contract language, read in the context of the entire contract, is not reasonably susceptible to more than one meaning, this 'objective' meaning will govern." *Id.* at 13 (citations omitted). It is only when contractual language in issue is reasonably susceptible to more than one meaning that extrinsic evidence will be considered to resolve the ambiguity. In that context, overt statements and acts of the parties, the business context, prior dealings between the parties, business custom and usage in the industry will all be considered. *Id.* at 14.

I would add to that, in the context of this case, I think it is appropriate to take into consideration, at the first level of analysis: (i) the Security Purchase Agreement the parties entered into at the same time as the Debenture, (ii) the Registration Rights Agreement the parties entered into at that time, and (iii) the opinion letter given by counsel for Strategic with respect to the terms of the Debenture, and in particular the contemplated issuance of shares pursuant to the conversion term of the Debenture. Those