Unreported Cases

INTRODUCTION

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

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FELDMAN v. CUTAIA

No. 1656-N

Court of Chancery of the State of Delaware, New Castle

April 5, 2006

Matthew E. Fischer, Esquire, Timothy R. Dudderar, Esquire, and Berton W. Ashman, Jr., Esquire, of Potter Anderson & Corroon, Wilmington, Delaware, for plaintiff.

Jon E. Abramczyk, Esquire, and Lisa Whittaker, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware, for defendants.

LAMB, *Vice Chancellor*

The complaint in this lawsuit discusses a series of transactions between March 2002 and August 2003 in which the Telx board of directors allegedly granted themselves a significant equity stake in the company for little or no consideration.[1] The plaintiff alleges that these transactions had the effect of significantly diluting his equity position in the company from 10.3% to approximately 1.5%. Moreover, the plaintiff claims that he was not informed about and was unaware of these events until after the transactions took place and that he was unaware of the participation of the individual defendants and their affiliates in these transactions until he received documents from the company in connection with a recently concluded books and records action filed pursuant to Section 220 of the Delaware General Corporation Law ("DGCL").[2]

In addition, the plaintiff asserts several claims with respect to an August 29, 2005 self-tender offer by the company for $5 million worth of its securities. First, the plaintiff alleges that the director defendants, who own approximately 89% of Telx's options and warrants, specifically

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[1]The facts recited in this opinion are taken from the well pleaded allegations of the amended complaint ("Compl."), unless otherwise noted, and are presumed to be true for the purposes of this motion.

[2]The plaintiff made a demand on Telx in accordance with 8 *Del. C.* § 220 on February 11, 2004, requesting books and records relating to the challenged transactions alleged in the complaint. When the plaintiff did not receive a response to his demand after several months, he brought a Section 220 action in this court on August 6, 2004. The parties settled the dispute in May 2005 when the company agreed to produce documents in several of the categories sought by the plaintiff. A formal stipulation and order of dismissal was entered on May 9, 2005.

structured the repurchase to include options and warrants and set the price term far above fair value in order to impart value to those otherwise underwater options and warrants.

Second, the plaintiff alleges that the repurchase caused an impairment of the company's capital in violation of Section 160 of the DGCL. The plaintiff asserts that, based on the financial information provided to the stockholders in the disclosure document accompanying the repurchase offer, it is apparent that "the repurchase amount of $5 million clearly exceeds Telx's surplus thus causing an impairment of Telx's capital in violation of 8 *Del. C.* § 160."[3]

Finally, the plaintiff claims that the repurchase offer disclosure document contains several material misstatements and omissions. The complaint alleges, among other things, that the defendants failed to disclose (1) an explanation for their decision to repurchase $5 million worth of securities, (2) how they arrived at the $10 repurchase price, and (3) why they chose to include options and warrants, which were predominantly owned by the Telx directors, in the repurchase.

With respect to the claims regarding the repurchase, the plaintiff seeks rescission of the repurchase of any company securities held by participating individual directors, and/or rescissory damages.

The defendants have moved to dismiss the amended complaint under Court of Chancery Rules 12(b)(6) and 23.1. The defendants argue that the plaintiff did not make a demand on the Telx board before proceeding with this derivative action and that the amended complaint does not plead with particularity facts that create a reasonable doubt as to the ability of the Telx board to independently consider such a demand. In addition, the defendants argue that the plaintiff's claims for wrongful dilution, breach of the fiduciary duty of loyalty, violation of 8 *Del. C.* § 160, breach of the fiduciary duty of candor, and rescission should all be dismissed for failure to state a claim upon which relief may be granted.

Oral argument was held on March 15, 2006, at which time the court denied the motion in its entirety. This opinion sets forth the reasons for the court's decision.

I.

A. The Parties

Nominal defendant The Telx Group, Inc. is a privately held

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[3]Compl. ¶ 44.

Delaware corporation with its principal place of business in New York, New York.[4] Telx is a start up company that provides interconnection facilities and services to telecommunications and internet companies.[5] The individual defendants, Rory J. Cutaia, Steven J. Kumble, Jonathan Lawrence, James T. Raymond, Llewellen Werner, William Hitchcock, and Leonard V. Sessa, comprise the current Telx board of directors. Cutaia is the Chief Executive Officer, President and Chairman of Telx's board of directors. Lawrence is Telx's Chief Financial Officer and Chief Operating Officer. It is alleged that the defendant directors, including their family members and entities which they control, collectively hold over 60% of the company's equity and approximately 89% of the company's outstanding options and warrants.

The plaintiff, Peter Feldman, was a co-founder, Chief Technology Officer, and is a former director of Telx.[6] Feldman is a record and beneficial owner of Telx common stock.

B. The Private Placement Offering, Exchange Transaction, Recapitalization, And Reverse Stock Split

In 2002, Telx conducted a private placement offering in which it offered common stock and debt in the form of senior secured and subordinated convertible promissory notes at a 16% interest rate due June 2005.[7] The plaintiff alleges that the documents obtained by him in the Section 220 action disclose that millions of dollars worth of the 16% notes were issued to Telx directors and officers, including five of the seven director defendants, Hitchcock, Sessa, Cutaia, Lawrence, and Raymond, individually and through their family members and entities they control.[8]

In April 2003, the company conducted an exchange transaction, pursuant to which the 16% notes issued in the private placement were exchanged for a combination of newly issued 9% senior secured

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[4]In August 2000, the company was incorporated in Delaware under the name CSP Holdings, Inc. and was renamed The Telx Group, Inc. in December 2000.

[5]Telx operates a carrier neutral interconnection facility in New York City that provides network access to more than 100 carrier and enterprise networks.

[6]The plaintiff co-founded Telx with defendant Cutaia and other investors.

[7]The total face value of the 16% notes issued equaled $7.05 million.

[8]Specifically, it is alleged that the following individual defendants and their affiliates received the 16% notes in the private placement: (i) Hitchcock and affiliates Avalon Financial Group, Ltd., Rosalie B. Hitchcock and Margaret M. Hitchcock Fanning, (ii) Sessa, (iii) Cutaia (through the Cutaia Group, L.L.C.), (iv) Lawrence and affiliate Joseph S. Lawrence, Jr., IRA, and (v) Raymond and affiliates Barbara K. Raymond, J. Todd Raymond, James F. Fitzgerald IRA, Mystic Island Corporation, Arthur & Elanor Foss, John E. Friend, II, M.D. and Kimberly K. Raymond, John Friend LLC, Kevin Lynch Trust and Friend Family Revocable Trust.

promissory notes and reduced strike prices on associated warrants to purchase Telx common stock.[9] A total of $5,543,797 of the senior secured 16% notes were exchanged for 9% notes, and approximately $1.1 million worth of the subordinated convertible 16% notes were converted into 3.3 million shares of Telx common stock at a price of $0.34 per share. Allegedly, Telx directors and officers, and their family members and entities they control, were significant participants in the exchange transaction, "exchanging millions of dollars of 16% notes they received in the private placement for 9% notes, warrants and common stock."[10] The same five director defendants that participated in the private placement, Hitchcock, Sessa, Cutaia, Lawrence, and Raymond, also participated in the exchange, individually and through their family members and entities they control.[11]

In August 2003, the company engaged in a recapitalization whereby the company received $3.8 million in cash and converted $7.8 million of debt and accrued interest into Series A preferred stock. The Series A preferred stock was convertible into Telx common stock on a ten-to-one basis.[12] Again, allegedly Telx directors and officers, including the five director defendants, Hitchcock, Sessa, Cutaia, Lawrence, and Raymond, individually and through their family members and entities they control, participated in the recapitalization, converting into Series A preferred stock millions of dollars of the 9% notes they received through the exchange transaction.[13]

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[9]The reduced strike prices ranged from $0.34 to $0.50 per share.

[10]Compl. ¶ 20.

[11]The following individual defendants and affiliates participated in the exchange transaction: (i) Hitchcock and affiliates Avalon Financial Group, Ltd., Rosalie B. Hitchcock and Margaret M. Hitchcock Fanning, (ii) Sessa, (iii) Cutaia (through the Cutaia Group, L.L.C.), (iv) Lawrence and affiliate Joseph S. Lawrence, Jr., IRA, and (v) Raymond and affiliates Barbara K. Raymond, J. Todd Raymond, James F. Fitzgerald IRA, Mystic Island Corporation, Arthur & Elanor Foss, John E. Friend, II, M.D. and Kimberly K. Raymond, John Friend LLC, Kevin Lynch Trust and Friend Family Revocable Trust.

[12]The Series A preferred stock was issued at four different prices depending upon the level of seniority of the debt exchanged: $1.80 per share for new capital and accrued interest and past-due debt; $2 per share for the senior secured 16% notes and the 9% notes; $3.40 per share for the subordinated convertible 16% notes; and $4 per share for the 12% and 10% junior subordinated debt.

[13]Specifically, the following individual defendants and their affiliates participated in the recapitalization by converting 9% notes into Series A preferred stock: (i) Hitchcock and affiliates Avalon Financial Group, Ltd., Rosalie B. Hitchcock and Margaret M. Hitchcock Fanning, (ii) Sessa, (iii) Cutaia (through the Cutaia Group, L.L.C.), (iv) Lawrence and affiliate Joseph S. Lawrence, Jr., IRA, and (v) Raymond and affiliates Barbara K. Raymond, J. Todd Raymond, James F. Fitzgerald IRA, Mystic Island Corporation, Arthur & Elanor Foss, John E. Friend, II, M.D. and Kimberly K. Raymond, John Friend LLC, Kevin Lynch Trust and Friend Family Revocable Trust.

In September 2003, Telx conducted a ten-to-one reverse stock split in which the preferred stock acquired in the exchange transaction and convertible into common stock on a ten-to-one basis became convertible into common stock on a one-to-one basis. These transactions indicated a value for the common stock ranging from $0.18 to $0.40 per share (or $1.90 to $4 per share assuming that the convertible feature was adjusted to one-to-one following the reverse stock split).

The plaintiff alleges that these transactions enabled the company's board and senior management, and their family members and entities they control, to amass holdings of approximately 60% of Telx's equity and 89% of Telx's outstanding options and warrants. It is alleged that these transactions also diluted Telx's common stockholders, including the plaintiff.[14] The plaintiff alleges that, based on the documents the company produced (and did not produce) pursuant to the Section 220 action, there are no records disclosing any consideration received by the company in exchange for the 16% notes issued to the director defendants, and their family members and entities they control, in the private placement.[15] Furthermore, with the exception of defendant Kumble, individual defendants, Hitchcock, Lawrence, Cutaia, Sessa, Raymond, and Werner,[16] either directly or through entities they control, were allegedly issued significant amounts of notes and securities in the private placement for little or no consideration.[17] In addition, the company's financial statements

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[14]Compl. ¶ 18.

[15]Compl. ¶ 23. According to the complaint, "[d]espite specifically requesting in the 220 Action 'all documents evidencing outstanding loans on which the Company is the obligor including . . . promissory notes, security interests [and] indentures' and agreeing to settle the 220 Action on the basis of a representation from the Company's counsel that the Company had produced 'supporting documents for equity investments in the March 2002 Private Placement and underlying promissory notes and debt agreements,' very few, if any, documents evidencing receipt of consideration by the company in exchange for securities issued pursuant to the Private Placement were produced to plaintiff."

[16]The court notes the inconsistency between ¶ 29 of the complaint (alleging that Werner received notes and securities in the private placement for little or no consideration) and ¶ 19 of the complaint (not listing Werner as a participant in the private placement).

[17]For example, allegedly defendant director Lawrence received a significant equity stake of Telx through these transactions for little or no consideration. Lawrence was issued 16% notes with a face value of $321,959 in the private placement. Following the exchange transaction, the recapitalization, and the reverse stock split, with little or no investment, Lawrence amassed a total of 256,369 shares of common stock or common stock equivalents. Excluding warrants and options, Lawrence held approximately 3.4% of the company's outstanding common stock or common stock equivalents as of October 31, 2004. Allegedly, despite specific requests from the plaintiff in the Section 220 action, the company did not provide any evidence of consideration in exchange for any of the securities Lawrence purportedly held, including the 16% notes and common stock, with the exception of two checks: one dated January 15, 2003 in the amount of $26,000 and the other dated August 12, 2003 in the amount of $5,000.

for 2002, the year in which the private placement took place, allegedly support the claim that a significant amount of the 16% notes were issued to the director defendants for grossly inadequate or no consideration.[18]

Moreover, the plaintiff claims that the documents produced through the Section 220 action raise questions concerning the procedure by which the Telx board approved these transactions. Allegedly, the recapitalization was consummated before the Telx board was informed about the fairness of the transaction. According to the complaint, "the recapitalization was completed by August 15, 2003, yet board minutes indicate that the defendants were not informed of the results of the fairness opinion by their financial advisor until August 21, 2003."[19] Furthermore, it is alleged that the board minutes reveal that as of a September 24, 2003 meeting the board still had not received a copy of the completed fairness opinion.

C. The Repurchase

On August 29, 2005, Telx announced an offer to repurchase up to $5 million worth of its securities. The repurchase was open to all holders, including directors and senior management, of common stock, Series A preferred stock, and vested options and warrants with an exercise price of less than $10 per share. The repurchase, which was set to expire on September 23, 2005, had a purchase price per share of common and preferred of $10, as well as $10 per option and warrant minus the underlying applicable exercise price.[20]

In the event that Telx security holders tendered more than $5 million worth of Telx's securities, the company would apply a proration formula to determine the percentage of securities that it would repurchase from each security holder. Based upon the proration formula, the repurchase guaranteed the largest share of the repurchase funds to those who held the most eligible securities.[21] Moreover, should the repurchase

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[18]The complaint states: "According to the Company's 2002 financial statements, the Company issued $7.05 million of 16% Notes in the Private Placement. However, the statement of cash flows contained in the same 2002 financial statement discloses that the Company received only $5.08 million in proceeds from long term debt in 2002—nearly $2 million less than the face value of the notes issued." Compl. ¶ 30.

[19]Compl. ¶ 31.

[20]To finance the repurchase, Telx sought a $5 million extension of credit with its current credit facility.

[21]According to the proration formula, Telx would purchase from each tendering security holder securities having a net equity value equal to the lesser of (1) the net equity value of the securities tendered by such security holder or (2) such security holders proportionate net equity value, as it related to the overall value of outstanding securities. Should security holders tender less than the proportionate net equity value of their securities, Telx would then purchase additional

be oversubscribed, holders of more than one type of security could choose to have the company repurchase a particular type of security first. Thus, for example, those who held common stock as well as options and warrants could tender their options and warrants first.

The plaintiff alleges that the company did not disclose any information indicating how it derived the $10 per share repurchase price, or the uniform pricing structure it offered for common and preferred stock classes as well as options and warrants. According to the complaint, "nothing in the Company's history, whether looking to its financial condition or the prices at which shares have historically or recently traded, indicates a per security price even approaching $10.00."[22] Allegedly, the Telx stock never sold for more than $4 per share (adjusted for the reverse stock split) and in most cases sold well below that amount. For example, the common stock was offered at $2.70 per share (adjusted for the reverse stock split) in the March 2002 private placement.[23] The complaint alleges that "nothing in Telx's performance or disclosed earnings in . . . the two or three years since the recapitalization and the private placement would justify a three- to five-fold increase in the value of Telx securities."[24] Therefore, the plaintiff claims that the $10 per security price is "severely inflated," presumably to give value to the options and warrants disproportionately held by the defendants.[25]

At the time of the repurchase, Telx directors and executive officers beneficially owned approximately 42% of Telx's common stock, 37% of Telx's outstanding Series A preferred stock, and, most significantly, approximately 89% of Telx's outstanding options and warrants.[26] The options and warrants, which were fully vested and convertible into Telx stock at any time, had exercise prices ranging from $0.10 to $3.40. Therefore, allegedly, the Telx directors who owned a large number of options and warrants at exercise prices well below the $10 repurchase price

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securities from those holders who tendered more than their proportionate net equity value, pro rata, based on the net equity value of their tendered securities.

[22]Compl. ¶ 37.

[23]Also, according to the complaint, in August 2003, pursuant to the recapitalization, the company retired approximately $7.8 million worth of debt in exchange for Series A preferred shares at between $1.80 and $4.

[24]*Id.*

[25]Compl. ¶¶ 37, 39. The company's presumed market capitalization contemplated in the repurchase would, accounting for all outstanding common and preferred stock as of July 31, 2005, equal $76,045,940. Allegedly, such a value exceeds by several times an appropriate market capitalization for a company in Telx's financial condition.

[26]According to the repurchase disclosure document, a group of eight unidentified Telx directors and executive officers beneficially owned, in the aggregate, 795,894 shares of common stock, 2,133,337 shares of Series A preferred stock, and 1,776,781 eligible options and warrants with exercise prices ranging from $0.10 to $3.40.

were to substantially benefit from the transaction. According to the complaint:

> The repurchase does not serve any legitimate corporate interest. Instead, it merely serves as a means for the Company's directors and senior management to cash in at least some of their holdings—holdings which they cannot demonstrate were properly acquired—at a per security price that exceeds by several times any reasonable estimate of their value.[27]

Furthermore, given the structure and terms of the repurchase, the defendants could tender their otherwise underwater options and warrants and receive a significant amount of the proceeds without diluting their ownership interest in the company.

II.

Section 141(a) of the DGCL provides that "the business and affairs of every corporation organized under this chapter shall be managed by or under the discretion of a board of directors."[28] Within this authority is the decision whether or not to bring litigation on behalf of the corporation.[29] Accordingly, a stockholder wanting to initiate a lawsuit on behalf of the corporation pursuant to Court of Chancery Rule 23.1 must first make demand on the corporations board of directors to take the requested remedial action or demonstrate the futility of such a demand.[30] The test of futility is whether at the time of the filing of suit a majority of the directors could have impartially considered and acted upon the demand.[31]

In *Aronson v. Lewis*, the Delaware Supreme Court held that, in determining demand futility, the court must decide whether, "under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business

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[27]Compl. ¶ 2.

[28]8 *Del. C.* § 141(a).

[29]*Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating that "[t]he demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of the corporation").

[30]*Brehm v. Eisner*, 746 A.2d. 244, 245-55 (Del. 2000).

[31]*Aronson*, 473 A.2d at 809-10 (stating that "futility is gauged by the circumstances existing at the commencement of a derivative suit").

judgment."[32] When determining whether a derivative complaint creates a reasonable doubt, "plaintiffs are entitled to all reasonable factual inferences that logically flow from the particularized facts alleged, but conclusory allegations are not considered as expressly pleaded facts or factual inferences."[33]

In this case, the plaintiff failed to make a pre-suit demand on the board. Instead, the complaint alleges that a majority of Telx's directors are incapable of impartially considering a demand to pursue claims relating to the challenged transactions. As discussed herein, the court finds that the plaintiff has met the first prong of *Aronson*. Therefore, the court will deny the defendants' motion to dismiss and permit the plaintiff to proceed with this derivative suit.

The plaintiff claims, *inter alia*, that a majority of the Telx directors engaged in self-interested transactions in violation of their duty of loyalty. The plaintiff's allegations with respect to the first prong of *Aronson* are two-fold. First, the plaintiff alleges that a majority of Telx directors received securities in the private placement transaction for little or no consideration. Second, the plaintiff alleges that a majority of the Telx directors engaged in a self-dealing transaction in which they caused the company to repurchase at a grossly inflated price options and warrants held almost exclusively by those directors. These allegations, if true, create a reasonable doubt that the directors were disinterested in approving the challenged transactions.

To establish director interest sufficient to excuse demand, the plaintiff must plead particularized facts showing that a majority of the Telx board had either a financial interest not equally shared by the stockholders, or an entrenchment purpose.[34] Here, the test is satisfied by the plaintiff's allegation, stated with particularity, that a majority of the directors received securities of the company in the private placement transaction for little or no consideration.[35] Furthermore, the allegations with respect to the repurchase suggest that the self-tender offer was an interested transaction subject to the entire fairness standard of review.

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[32]*Id.* at 814.

[33]*Brehm*, 746 A.2d at 255.

[34]*Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988).

[35]At oral argument, the defendants maintained that, because the Telx outside financial auditors certified the company's financial statements, it is reasonable to conclude that valuable consideration was paid to the company. The court cannot reasonably rely at a motion to dismiss stage on a mere statement made by a defendant that an outside auditor certified the financials of the company. The issue is whether the director defendants paid consideration for the notes they received in the private placement. This is an issue of objective fact that cannot be proved by the existence of an auditor's certification.

The defendants argue that the repurchase is not an interested transaction because all security holders can participate in the transaction on equal terms. They contend that, even though the directors had a financial interest in the offer in the sense that they owned Telx securities, they did not have an interest in the offer that would disqualify them from objectively considering a demand to bring derivative claims related to that offer. The court is unable to accept this argument because, taken as true, the particularized allegations of fact in the complaint support a reasonable probability that a majority of the Telx directors were financially interested in the repurchase and stand to receive a financial benefit *not* equally shared by the company's stockholders.

By deciding to include options and warrants in the repurchase, the directors, who owned approximately 89% of Telx's options and warrants, allowed themselves to claim a larger percentage of the repurchase proceeds. Allegedly, the repurchase was structured such that the directors could potentially receive a disproportionate benefit from the transaction than they would otherwise have been entitled to had the repurchase only included outstanding common stock.[36] Thus, the decision to include options and warrants in the repurchase, while not necessarily suspect, when coupled with the other factors discussed next, suggests that the individual director defendants placed their own interests above those of the Telx stockholders.[37] Similarly, the proration formula allowed the directors to first tender their options and warrants in the repurchase without a concomitant reduction of their ownership percentage in the company. To the extent that the directors planned to tender their options and warrants while retaining their common and preferred stock, they could be unfairly advantaging themselves to the detriment of the common stockholders.

Most important, by setting the repurchase price at $10, the directors made it possible to receive cash for their options and warrants at a price allegedly far in excess of the value of these securities. Had the directors

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[36]The number of options and warrants eligible for repurchase was substantial. Indeed, the amount of options and warrants eligible for repurchase was greater than the total amount of common stock outstanding.

[37]In addition, the court notes that the directors may have improperly put the interests of the option and warrant holders above the interests of the common stockholders. The Delaware Supreme Court has consistently held that directors do not owe fiduciary duties to future stockholders. *See Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988) (holding that a "convertible debenture represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties"); *Cont'l Airlines v. American Gen.*, 575 A.2d 1160, 1168 (Del. 1990) (explaining that warrant holders are only protected by contractual rights); *Glinert v. Wickes Cos.*, 586 A.2d 1201 (Del. 1990) (holding that a corporation did not owe a fiduciary duty to future stockholders).

instead priced the repurchase at what is alleged to be fair value, many, if not all of the options and warrants would have been "out of the money." Instead, the directors allegedly chose "to cash out these securities at a price well above their exercise price and well above a price these holders would otherwise be able to obtain without the repurchase."[38] In addition, the claim that the company did not disclose why the directors chose a $10 repurchase price or how this price was calculated further supports the suggestion that the directors had an improper motive to cash out their less valuable (or valueless) options and warrants at an inflated price.[39]

For these reasons, the court concludes that the plaintiff has alleged with particularity facts which, if true, are sufficient to raise a reasonable doubt as to whether the directors could properly entertain the plaintiff's demand. Accordingly, the court will deny the defendants' motion to dismiss pursuant to Rule 23.1.

III.

The defendants have also moved under Court of Chancery Rule 12(b)(6) to dismiss the claims that: (1) the repurchase violates Section 160(a)(1) of the DGCL; and (2) the directors breached their fiduciary duty of candor by disseminating a disclosure document pursuant to the repurchase that contains material misstatements and omissions.

The standard for dismissal pursuant to Rule 12(b)(6) for failure to state a claim upon which relief can be granted is well established. A motion to dismiss will be granted if it appears with reasonable certainty that the plaintiff could not prevail on any set of facts that can be inferred from the pleading.[40] That determination is generally limited to the factual allegations contained in the complaint. In considering this motion, the court must assume the truthfulness of all well pleaded allegations of fact in the complaint.[41] All well pleaded facts and inferences that can reasonably

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[38]Compl. ¶ 42.

[39]In addition, the Telx directors have acknowledged in the disclosure document that the board has explored a possible merger transaction with a third party or another recapitalization. Allegedly, "[t]he repurchase therefore affords the individual defendants the opportunity to cash in a significant portion of their holdings now at a per share value that the individual defendants know would not be available in a negotiated transaction with a third party such as a merger or recapitalization." Compl. ¶ 41.

[40]*Kohls v. Kenetech*, 791 A.2d 763, 767 (Del. Ch. 2000).

[41]*Grobow*, 539 A.2d at 188 n.6 (upon a motion to dismiss, "all facts of the pleadings and reasonable inferences to be drawn therefrom are accepted as true, but neither inferences nor conclusions of fact unsupported by allegations of specific facts upon which the inferences or conclusions rest are accepted as true").

be drawn therefrom are accepted as true.[42] However, with that said, a trial court need not blindly accept as true all allegations, nor must it draw all inferences from them, in the plaintiff's favor unless they are reasonable inferences.[43]

A. Section 160(a)(1)

The plaintiff alleges that Telx's repurchase of its shares will cause an impairment of Telx's capital within the meaning of 8 *Del. C.* § 160(a)(1). The plaintiff bases his allegation on the pro forma balance sheet provided in the disclosure document which reveals that the repurchase amount of $5 million far exceeds Telx's surplus.[44] Section 160(a)(1) provides that a corporation may not repurchase or redeem its own shares "when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation." A repurchase impairs capital if the funds used in the repurchase exceed the amount of the corporations surplus, as defined in 8 *Del. C.* § 154 to mean the excess of net assets over the par value of the corporation's issued stock.

The defendants rely on *Klang v. Smith's Food and Drug Centers* for the proposition that Section 160 was not violated because the company has the ability to revalue its assets to conform to the requirements of the statute.[45] It is true that, in *Klang*, the Delaware Supreme Court held that a corporation *may* revalue its assets and liabilities to show a surplus and thus conform to Section 160.[46] Unlike in *Klang*, however, where the board in fact appropriately revalued its corporate assets to comply with the statute, here it is alleged that the Telx board did not perform such a revaluation.[47] Moreover, *Klang* was decided after the parties took full discovery and the court had before it a fully-developed factual record.[48] In the present matter, the court is confined to the allegation in the complaint that the company lacked adequate surplus and did not revalue its assets to create sufficient surplus.

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[42] *Id.*

[43] *Id.*; *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 727 (Del. Ch. 1999).

[44] According to the summary balance sheet contained in the disclosure document, Telx has total assets of $63,554,213 and total liabilities of $61,561,337, which results in net assets of $1,992,876. Subtracting the aggregate par value of Telx's outstanding equity ($76,045) from its net assets leaves a surplus within the meaning of 8 *Del. C.* § 154 of $1, 916,831. Therefore, the repurchase amount of $5 million exceeds Telx's surplus, resulting in an impairment of Telx's capital in violation of 8 *Del. C.* § 160.

[45] 702 A.2d 150, 154 (Del. 1997).

[46] *Id.*

[47] *Id.* at 155.

[48] *Id.* at 153.

In the circumstances, it would be unreasonable for the court to assume, contrary to the well pleaded facts, that the company actually revalued its assets to comply with Section 160. Such an assumption would effectively render meaningless the statutory prohibition against conducting a repurchase that impairs the company's capital. Accordingly, the court finds that the plaintiff has properly alleged a claim that the repurchase violated Section 160(a)(1).

B. Disclosure Claims

The plaintiff alleges that the Telx directors breached their fiduciary duty of candor by disseminating a disclosure document with respect to the repurchase that contains several material misstatements and omissions. Specifically, the plaintiff claims, *inter alia*, that the defendants failed to fully and accurately disclose in the offer to purchase (1) relevant, up-to-date financial information, (2) the justification for their decision to repurchase $5 million worth of Telx stock with borrowed funds, (3) any information concerning the source or derivation of the $10 per security purchase price, (4) the effect on common stockholders if they decide not to participate in the repurchase, (5) the nature and extent of the directors' ownership and intended participation in the repurchase, (6) why they included options and warrants in the repurchase, and (7) whether Telx was engaged in preliminary merger negotiations at the time it commenced the repurchase.[49]

Under Delaware law, "a board of directors is under a fiduciary duty to disclose material information when seeking shareholder action."[50] This fiduciary disclosure obligation involves the affirmative duty to provide information, the duty to be materially accurate and complete with respect to the information that is provided, and the duty to be entirely fair by fully

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[49]Moreover, the plaintiff claims that prior to the expiration date of the repurchase he wrote to the company expressing his concerns regarding the omission of material information in the disclosure document. Allegedly, he was told that the company would disseminate a supplement to the disclosure document which would address his concerns. The plaintiff claims never to have received any supplemental disclosures.

[50]*Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998) *citing Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 137-38 (Del. 1997) ("Delaware law of the fiduciary duties of directors . . . establishes a general duty to disclose to stockholders all material information reasonably available when seeking stockholder action . . . . But there is no per se doctrine imposing liability . . .); *Arnold v. Soc'y for Sav. Bancorp*, 650 A.2d 1270, 1277 (Del. 1994) (a fiduciary disclosure obligation "attaches to proxy statements and any other disclosures in contemplation of shareholder action"); *Stroud v. Grace*, Del. Supr., 606 A.2d 75, 84 (Del. 1992) ("directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the boards control when it seeks shareholder action").

disclosing material information.[51] Here, the plaintiff alleges that the stockholders could not make an informed decision on whether to participate in the tender offer because the company's disclosure document is materially misleading.

The complaint adequately alleges that the directors failed to disclose all facts material to the tender offer.[52] In particular, the failure to adequately disclose the purpose of the transaction and how the unusually high $10 per security purchase price was derived may prove to be material omissions.[53] The duty to disclose material information such as this is especially important where, as here, the securities that are the subject of the repurchase are not publicly traded, leaving the stockholders without a market price against which to measure the adequacy of the proposal.

Lastly, the plaintiff alleges that the disclosure document did not adequately disclose that certain Telx directors had a potential conflict of interest by reason of their ownership of significant amounts of Telx options and warrants. Allegedly, a conflict exists between the directors and the common stockholders because the directors, who owned approximately 89% of Telx options and warrants, could disproportionately benefit over the common stockholders in the tender offer. If true, the common stockholders are entitled to know that certain of their fiduciaries had a self-interest that was arguably in conflict with their own interests.[54] Therefore, the court will not dismiss the plaintiff's disclosure claims at this early stage of the litigation, before the basic facts relating to the challenged transactions and the repurchase offer are established of record.

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[51] *See Stroud*, 606 A.3d at 84 (recognizing an affirmative duty to provide information to stockholders); *see also Shell Petroleum v. Smith*, 606 A.2d 112, 114 (Del. 1992); *Kahn v. Roberts*, 679 A.2d 460, 462 (Del. 1996) (finding a duty to be materially accurate and complete when management is seeking stockholder action); *see also Arnold*, 650 A.3d at 1277; *Sealy Mattress Co. of N.J. v. Sealy Inc.*, 532 A.2d 1324, 1340 (Del. Ch. 1987) (holding that the duty of fairness includes an obligation to make full disclosure).

[52] *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1057 (Del. Ch. 1987) ("Where a corporation tenders for its own shares, the exacting duty of disclosure imposed upon corporate fiduciaries is even" more onerous" than in a contested offer. That is because in a self-tender, the disclosures are unilateral and not counterbalanced by opposing points of view.").

[53] *See Gaffin v. Teledyne*, 611 A.2d 467, 473 (Del. 1992); *see also Eisenberg*, 537 A.2d at 1059 (explaining that "the shareholder-offerees are entitled to an accurate, candid presentation of why the self-tender is being made" and "are to be informed of information in the fiduciaries' possession that is material to the fairness of the price").

[54] *Eisenberg*, 537 A.2d at 1061 (explaining that directors are obligated to disclose their conflict of interest with respect to a self-tender offer).

IV.

For the foregoing reasons, the defendants' motion to dismiss pursuant to Rule 12(b)(6) is DENIED. IT IS SO ORDERED.

GILDOR v. OPTICAL SOLUTIONS, INC.

No. 1416-N

Court of Chancery of the State of Delaware, New Castle

June 5, 2006

Bruce E. Jameson, Esquire, Eric M. Andersen, Esquire, and David W. Gregory, Esquire, of Prickett, Jones & Elliott, P.A., Wilmington, Delaware; and Steven M. Kayman, Esquire, Proskauer Rose LLP, New York, New York, of counsel, for plaintiff.

Stephen E. Herrmann, Esquire, and Steven J. Fineman, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and Wendy J. Wildung, Esquire, and Erik J. Girvan, Esquire, of Faegre & Benson, Minneapolis, Minnesota, of counsel, for defendant.

STRINE, *Vice Chancellor*

This case is before me on cross-motions for summary judgment. A preferred shareholder, plaintiff Yechezkel Gildor, filed this case in an attempt to assert his preemptive rights to buy certain new preferred shares issued by a privately-held company in which he invested, defendant Optical Solutions, Inc. Optical Solutions does not dispute that Gildor had preemptive rights that were triggered by Optical Solutions' decision to undertake a new round of preferred equity financing (the "New Issuance"). Rather, the key dispute is whether Optical Solutions complied with the notice requirements of the Third Amended and Restated Stockholders' Agreement (the "Stockholder Agreement") in seeking to inform Gildor of his opportunity to exercise his preemptive rights and participate in the New

Issuance.

Optical Solutions sent notice of the New Issuance through Federal Express ("FedEx") to Gildor at the address he provided in a Subscription Agreement, which was the Agreement that bound Gildor to purchase his preferred shares in the first instance. That address was not reflected in the Stockholder Agreement, where the notice provision at issue is found. After attempting to deliver the notice, FedEx informed Optical Solutions that the recipient, Gildor, was not at that address. To make sure it had not misaddressed the first package, Optical Solutions sent a second notice to the same address provided in the Subscription Agreement. When it was returned unclaimed for the second time, Optical Solutions did not undertake any further efforts to find Gildor, although it had in its records an alternate address and other contact information previously provided by Gildor.

Gildor brings this suit alleging that Optical Solutions breached the Stockholder Agreement and violated its implied duty of good faith and fair dealing by not undertaking further efforts to notify him about the need to exercise his preemptive rights. For its part, Optical Solutions claims that its only duty was to comply with the notification provisions of the Stockholder Agreement and that it fulfilled its duty by sending notice to Gildor twice by overnight courier at the address he provided in the Subscription Agreement.

In this opinion, I conclude that Optical Solutions did not fulfill its contractual duty to notify Gildor. The problem for Optical Solutions is that the Stockholder Agreement has a clear notice provision, which it did not satisfy. Under the plain terms of the Stockholder Agreement, notice was to go to recipients at the address reflected in the schedules to the Stockholder Agreement. Optical Solutions, though, did not attach such a schedule to the Stockholder Agreement, so the address Optical Solutions used necessarily was not listed in any schedule to the Stockholder Agreement.

Nor does the record contain any evidence that Optical Solutions required Gildor to provide a notice address on his Stockholder Agreement signature page or in conjunction with the Stockholder Agreement. Instead, Optical Solutions opted to rely on an address that was provided in the Subscription Agreement and that was listed in exhibits to two other documents executed at the same time as the Stockholder Agreement—the Preferred Stock Purchase Agreement (the "Purchase Agreement") and the Third Amended and Restated Registration Rights Agreement (the "Registration Rights Agreement"). Reliance by Optical Solutions on the address provided in the other documents, however understandable, did not comply with the Stockholder Agreement.

Had Optical Solutions created a schedule of addresses for notice,

as the Stockholder Agreement contemplated, its only duty would have been to adhere to the contract. Confronting a situation, however, where it was impossible to give notice in accordance with the contract, and realizing that notice failed to reach Gildor at the address he provided in the Subscription Agreement, Optical Solutions was not free to take no further action. Rather, Optical Solutions was required to comply substantially with that notice provision by taking further reasonable efforts to notify Gildor. Optical Solutions' own files contained several contact methods provided by Gildor, including an address that he had provided as his record address within the past two years, an email address, a phone number, and a fax number. Optical Solutions, then, had low cost methods by which to seek to provide actual notice. It failed to do so, clinging to the erroneous belief that it had complied with the literal terms of the Stockholder Agreement.

I. Factual Background

These are the undisputed facts that emerge from the parties' cross-motion papers. The plaintiff, Gildor, is a preferred shareholder of Optical Solutions who resides in Israel. Gildor holds 1,055,522 of Optical Solutions' Series F preferred shares, purchased at $0.1579 per share, and another 42,517 Series D preferred shares, purchased for $11.76 per share. Gildor first invested in Optical Solutions in September 2000, when he purchased the Series D shares. He later purchased the Series F shares in April 2002 pursuant to the Subscription Agreement. Gildor's Series D and F preferred shares were acquired for a total of approximately $667,000. Gildor's investment, at all times, was managed by his brother Ephraim Gildor, who is a money manager in New York City.

A. Gildor's Addresses

The various addresses provided by Gildor to Optical Solutions are important in determining the outcome of this case. Initially, when Gildor purchased his Series D shares in 2000, he listed his address as:

Hezi Gildor
163 John St.
Greenwich, CT 06831

This is the "Connecticut Address." The Connecticut Address was provided expressly by Gildor as his "New Address of Record" on an Optical

Solutions form when purchasing the Series D shares.[1] In actuality, Gildor himself resided in Israel but his brother and financial advisor, Ephraim, lived at the Connecticut Address. Shortly after purchasing his Series D shares, Gildor submitted a change of address form to Optical Solutions. That change of address form merely clarified that Gildor himself lived in Israel, while his brother Ephraim lived at the Connecticut Address. Gildor continued to want communications to go to the Connecticut Address. In fact, on the change of address request form, Gildor expressly wrote "Please contact" above the Connecticut Address.[2]

More than a year after providing the Connecticut Address as his record address and submitting the change of address form, Gildor executed a Subscription Agreement to purchase Series F preferred shares on April 29, 2002. On the signature page of the Subscription Agreement, Gildor provided the following address as his "Mailing Address:"

c/o Ephraim Gildor
Gildor Trading
712 5th Ave. 6th Fl.
New York, NY 10019

This is the "New York Address." The Subscription Agreement's signature page indicates that the Series F stock certificates will be sent to the New York Address. The signature page of the Subscription Agreement also contained another address block adjacent to the Mailing Address block, which was labeled "Residence Address." The preferred stockholder was to complete the Residence Address block "if different from Mailing Address." As Gildor did not provide an alternate residence address in the Subscription Agreement, it is reasonable to infer that Gildor intended to have the New York Address serve as both his mailing and residence addresses. Indeed, his counsel candidly conceded as much at oral argument.[3] The Subscription Agreement, though, never referred to the New York Address as Gildor's record address or requested from Gildor a "New Address of Record," which was the lexicon Optical Solutions used when Gildor was asked to provide an address in connection with his purchase of Series D shares.

Approximately one week later, on May 9, 2002, Gildor executed several other documents to complete his purchase of the Series F shares. Those documents included the Purchase Agreement, the Registration

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[1]Gildor's Ex. 2.
[2]Aff. of Dagenais Exs. B, C.
[3]Tr. at 41.

Rights Agreement, and the Stockholder Agreement. Exhibit A to the Purchase Agreement lists Gildor's address as the New York Address, and Exhibit E to the Registration Rights Agreement also lists Gildor's address as the New York Address. Presumably, the address list that was provided as an exhibit to those two agreements was compiled from the addresses that the preferred stockholders provided in the Subscription Agreement. The preemptive rights that Gildor now seeks to vindicate were provided for in the Stockholder Agreement—not in the Subscription, Purchase, or Registration Rights Agreements.

B. The Pertinent Provisions Of The Stockholder Agreement

The preemptive rights contained in § 4(a) of the Stockholder Agreement required Optical Solutions first to notify "each Series B Holder, Series C Holder, Series D Holder, and Series F Holder of such proposed transaction and offer to sell to each . . . a portion of such stock or securities . . . ." The portion that was required to be offered was, in simplified terms, that which was necessary to prevent the existing Holders from being diluted by the later offering.[4] Therefore, § 4(a) entitled each holder of a prior series of preferred stock to buy into the New Issuance "at the most favorable price and on the most favorable terms as such stock or securities are to be offered to any other Persons."

A central issue before me now is whether Optical Solutions properly notified Gildor of the New Issuance as required by § 4(a) of the Stockholder Agreement. The Stockholder Agreements notice provision, § 16(g), provides that:

> *Any notice provided for in this Agreement shall be in writing and shall be either personally delivered, by facsimile or mailed first class mail (postage prepaid) or sent by reputable overnight courier service (charges prepaid) to the Company at the address set forth below and to any other recipient at the address indicated on the schedules hereto* and to any subsequent holder of Stockholder Shares subject to this Agreement at such address as indicated by the Company's records, or at such address or to the attention of such other person as the recipient party has specified by prior written notice to the

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[4]Stockholder Agmt. § 4(a).

> sending party. Notices shall be deemed to have been given hereunder when delivered personally, sent by facsimile, upon receipt if sent through the U.S. mail and one day after deposit with a reputable overnight courier service . . . .[5]

Section 16(g), then, requires Optical Solutions to provide notice to "other recipients," i.e., Gildor, at the address in the schedules to the Stockholder Agreement.[6] Optical Solutions did not attach an address schedule to the Stockholder Agreement. In addition, the Stockholder Agreement signature page provided to Gildor by Optical Solutions did not contain an address block directing Gildor to provide an address for notice.[7]

C. Optical Solutions Attempts To Notify Gildor Of The New Issuance

This case arises because in mid-2003, Optical Solutions decided to raise capital through the New Issuance. On or about June 4, 2003, Optical Solutions sent notice of the New Issuance to over 300 holders of certain series of preferred shares. Optical Solutions used the addresses that the preferred shareholders provided in the Subscription Agreement when sending that notice. The Stockholder Agreement, though, did not reference the address provided in the Subscription Agreement as an acceptable address for providing notice.

Of these over 300 preferred stockholders, Optical Solutions sent out notice using FedEx to approximately 280, only four of which were not delivered, and sent out notice to the remaining preferred stockholders using first-class mail because those holders provided a post office box, rather than a physical address. Optical Solutions claims that this method of notice complied with § 16(g) of the Stockholder Agreement and that it had no obligation to take further steps to track down the preferred shareholders

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[5]Emphasis added.

[6]Gildor was not a "subsequent holder of Stockholder Shares," so the provision for sending notice to "such address as indicated by the Company's records" was not applicable directly to him. Gildor was an original holder. In the Stockholder Agreement, the definition of "Stockholder Shares" is, essentially, "any Common Stock." The Stockholder Agreement further states that "any Person who holds Preferred Stock shall be deemed to be the holder of the Stockholder Shares issuable directly or indirectly upon conversion of the Preferred Stock." This notice provision was presumably designed to cover a person who purchased preferred stock from the original preferred stockholders who had the option to convert their shares.

[7]A Joinder Agreement that would allow a subsequent purchaser to buy Series F shares after the execution of the Stockholder Agreement, though, does in fact have a spot for "notice address." Index of Joint Submissions Ex. 15.

who did not receive the notice at the address provided in the Subscription Agreement.

As to Optical Solutions' specific efforts to notify Gildor, Optical Solutions employed FedEx on June 4, 2003 to deliver the notice of the New Issuance to Gildor at the New York Address, which was the address provided in the Subscription Agreement. The FedEx airbill indicates that the notice was scheduled for standard overnight delivery and that, when FedEx attempted to deliver the package, the recipient was not at the address listed.[8] As a result, FedEx destroyed the package.[9]

After learning that FedEx could not deliver the notice to the New York Address, Optical Solutions again attempted on June 25, 2003 to provide the notice via overnight FedEx to the New York Address, presumably in order to ensure that neither Optical Solutions nor FedEx erred the first time notice was sent. Again, the package was not delivered. The reason is now clear—Ephraim's business was no longer located at the New York Address. Neither Gildor nor his brother Ephraim ever contacted Optical Solutions to inform it that Ephraim's business had changed locations and that the New York address would no longer work.

Given that the notice failed to reach him, Gildor claims that he did not learn of the New Issuance until July 2004, which was approximately a year after the first offering of shares in New Issuance had closed. Gildor states that, even as of July 2004, he would not have learned about the New Issuance except that Ephraim had fortuitously contacted Optical Solutions at that time to inquire about the company's financial performance. During that call, apparently someone at Optical Solutions informed Ephraim about the New Issuance, which had closed the second tranche offering of preferred shares in early 2004. When Gildor asked to participate in the New Offering, Optical Solutions refused to allow him to exercise his preemptive rights. This lawsuit then ensued.

Gildor now argues that Optical Solutions' attempts to provide notice of this New Issuance were deficient because Optical Solutions sent it to an address that was not his notice or record address, which ultimately resulted in a dilution of his Optical Solutions ownership. Optical Solutions argues that it complied with the notice provision of the Stockholder Agreement by sending notice to Gildor's New York Address. The issue, then, is whether Optical Solutions was required by the Stockholder Agreement to provide notice to Gildor at an address other than the New York Address.

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[8]App. to Gildor's Op. Brief at 5.
[9]*Id.*

II. Procedural Framework

Gildor and Optical Solutions have filed cross-motions for summary judgment, both contending that the plain language of the relevant contracts and applicable law warrant summary judgment. Typically, to prevail on a motion for summary judgment, each moving party must show that no genuine issue exists as to any material fact and that it is "entitled to judgment as a matter of law."[10] Here, the parties are taking advantage of a recent amendment to Court of Chancery Rule 56, which now states:

> Where the parties have filed cross motions for summary judgment and have not presented argument to the Court that there is an issue of fact material to the disposition of either motion, the Court shall deem the motions to be the equivalent of a stipulation for decision on the merits based on the record submitted with the motions.[11]

Both Gildor and Optical Solutions contemplate the resolution of this matter on the written record and do not argue that an issue of material fact precludes summary judgment. Therefore, I will treat the cross-motions for summary judgment as a submission for a judgment on the merits as required by Rule 56(h).

In his complaint, Gildor states only one claim—breach of contract, including breach of the implied covenant of good faith and fair dealing. My task, therefore, involves the interpretation of contractual language, and initially, I will focus solely on the language of the contract itself. If that language is unambiguous, its plain meaning alone dictates the outcome.[12] In determining a contract's meaning, "the language of an agreement, like that of a statute, is not rendered ambiguous simply because the parties in litigation differ concerning its meaning."[13] Rather, it is for the court to determine whether the contested provisions are "reasonably or fairly susceptible of different interpretations or may have two or more different meanings."[14]

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[10]*Acro Extrusion Corp. v. Cunningham*, 810 A.2d 345, 347 (Del. 2002).

[11]Ct. of Ch. R. 56(h).

[12]*Pellaton v. The Bank of New York*, 592 A.2d 473, 478 (Del. 1991).

[13]*City Investing Co. Liquidating Trust v. Contl Cas. Co.*, 624 A.2d 1191, 1198 (Del. 1993).

[14]*Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992).

III. Legal Analysis

The core of Gildor's complaint is that he failed to receive notice of an event that would trigger his preemptive rights. The question is whether the failure of the notice to reach Gildor is the contractual fault of him or is the contractual fault of Optical Solutions.

A. Did Optical Solutions Comply With The Stockholder Agreement By Sending Notice To Gildor's New York Address?

The manner in which Optical Solutions is required to provide notice to Gildor, and other preferred stockholders, is stated expressly in § 16(g) of the Stockholder Agreement. The language of § 16(g) is clear and unambiguous, which means that the language alone would typically dictate the outcome.[15] That section provides that "[a]ny notice provided for in this Agreement" will be "personally delivered, by facsimile or mailed first class mail . . . or sent by reputable overnight courier service . . . to the Company at the address set forth below and to any other recipient at the address indicated on the schedules hereto." Optical Solutions' primary problem is that the Stockholder Agreement did not contain a schedule that listed an address for Gildor, or apparently for any other preferred stockholder. As a result of failing to include Gildor's address in a schedule, literal compliance with § 16(g) was impossible.

Despite the lack of a schedule or notice address contained in the Stockholder Agreement, Optical Solutions attempted to notify Gildor of the New Issuance at the New York Address. Optical Solutions points to the fact that Gildor provided the New York Address in the Subscription Agreement and that the New York Address was listed as Gildor's address in Exhibit A to the Purchase Agreement and in Exhibit E to the Registration Rights Agreement. The Stockholder Agreement, though, makes no reference to any address provided in the Subscription, Purchase, or Registration Rights Agreement.[16] In fact, § 16(c) of the Stockholder

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[15] *Pellaton*, 592 A.2d at 478.

[16] Though argued by neither party, precedent exists suggesting that contracts entered into at the same time and relating to the same subject matter should be construed together as a single contract in the appropriate circumstances. *See Simon v. The Navellier Series Fund*, 2000 WL 1597890, at *7 (Del. Ch. Oct. 19, 2000); *Crown Books Corp. v. Bookstop, Inc.*, 1990 WL 26166, at *1 (Del. Ch. Feb. 28, 1990). *See also* RICHARD A. LORD, 11 WILLISTON ON CONTRACTS § 30:26 (4th ed.); 17A *C.J.S. Contracts* § 315 (2005). In this case, the parties expressed their intent in writing, through the inclusion of an integration clause in § 16(c) of the Stockholder Agreement, that the agreements not be considered as one. In addition, each agreement contained its own notice provision, and the notice provisions in various agreements differed in important ways, including as to the manner by which notice was to be delivered.

Agreement states that "this Agreement embodies the complete agreement and understanding among the parties hereto . . . ."

It is possible that Optical Solutions contemplated that the address provided by the preferred stockholders in the Subscription Agreement and listed in the Purchase and Registration Rights Agreements would become the notice address for all notices to the Series F preferred stockholders under all the related agreements, including the Stockholder Agreement. But Optical Solutions did not provide Gildor with a clear statement to that effect in any of the documents it provided to him. For example, the Subscription Agreement signed by Gildor could have contained a clear statement indicating that the "address provided will supersede all previous addresses provided to Optical Solutions and will serve as the address of record for all notices under this Agreement and any other agreement between the holder and Optical Solutions." No language of this kind appears in that document. Likewise, there is no other document that can be interpreted as unambiguously incorporating the New York Address provided by Gildor under the Subscription Agreement as a schedule to the Stockholder Agreement. Therefore, Optical Solutions could not rely on the New York Address to comply with § 16(g) of the Stockholder Agreement.

All the agreements provided to the preferred stockholders during the Series F offering, including the Subscription, Purchase, Registration Rights, and Stockholder Agreements, were drafted by Optical Solutions. Optical Solutions had numerous options, when drafting those agreements, as to how it would provide notice and to what address it would provide notice. In fact, the Purchase Agreement and Registration Rights Agreement have their own notice provisions. The Purchase Agreement provides that notice will be sent "to the party to be notified at such party's address as set forth on the signature page or Exhibit A hereto." Exhibit A to the Purchase Agreement, in fact, contains an address for Gildor. The Registration Rights Agreement provides that notice will be addressed to "the party to be notified as such party's address or fax number as set forth in the Company's records." Optical Solutions, then, could search its records in order to comply with the Registration Rights Agreement, which is a simple step Optical Solutions failed to take when attempting to notify Gildor of the New Issuance pursuant to the Stockholder Agreement. Interestingly, Exhibit E to the Registration Rights Agreement is the same document that is attached to the Purchase Agreement as Exhibit A. The notice provision of the Registration Rights Agreement, though, failed even to mention Exhibit E or any other schedule as a source of addresses for notice and, as discussed, opted to rely on a preferred stockholder's record address. Exhibit A to the Purchase Agreement and Exhibit E to the Registration Rights Agreement, then, listed Gildor's address as the New York Address

but failed to indicate in any way that Gildor had changed his address of record or that the New York Address would be used as a general notice address.

Having put itself in a position in which it was impossible to give notice in precise conformity with the Stockholder Agreement, Optical Solutions relied on addresses received under the Subscription Agreement. Thus, it instructed FedEx to deliver notice to Gildor at the New York Address. After FedEx informed Optical Solutions that Ephraim's business was no longer at the New York Address, Optical Solutions attempted to send notice to that address again—presumably in order to ensure that neither it nor FedEx made an error. That second delivery also failed.

At that point, then, the situation was that Optical Solutions had attempted to send notice to an address that did not comply with the express terms of the Stockholder Agreement, and Optical Solutions had been notified by FedEx that the notice required under the Stockholder Agreement had not reached Gildor. Facing that situation, Optical Solutions chose to do nothing else to notify Gildor. If Optical Solutions had complied with the Stockholder Agreement, even if it knew that the notice did not reach Gildor, it would have been under no further obligation to search for him.[17] That was not the case here. Optical Solutions' failure to

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[17]Gildor argues that, even in the circumstance when an issuer complies with the notice terms of a contract, once the issuer learns that the contractually-compliant notice failed to reach the investor, the issuer owes the investor a duty to take reasonable further steps to locate her. Gildor argues that an implied covenant of good faith and fair dealing would require this type of reasonable search. That is not so. The implied covenant of good faith and fair dealing "cannot contravene the parties' express agreement and cannot be used to forge a new agreement beyond the scope of the written contract." *Chamison v. HealthTrust, Inc.*, 735 A.2d 912, 921 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Table); *see also Automodular Assemblies (DE), Inc. v. PNC Bank, Delaware*, 2004 WL 1859828, at *7 n.7 (Del. Ch. Aug. 6, 2004); *Metro Commc'n Corp. BVI v. Advanced Mobilecomm Tech. Inc.*, 854 A.2d 121, 142 (Del. Ch. 2004). A court should not read a reasonableness requirement into a contract entered into by two sophisticated parties. It is imperative that contracting parties know that a court will enforce a contract's clear terms and will not judicially alter their bargain, so courts do not trump the freedom of contract lightly. *See, e.g.*, *Abry Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1059-60 (Del. Ch. 2006); *Libeau v. Fox*, 880 A.2d 1049, 1056-57 (Del. Ch. 2005), *aff'd in pertinent part*, 2006 WL 196379 (Del. Jan. 24, 2006). The fairness of a judicial rule requiring a company to search for preferred stockholders who do not keep their contractual addresses current is of grave doubt, as these searches would waste company resources and come at the expense of stockholders who maintained current addresses on file with the company. It is not uncommon for an issuer to have thousands of stockholders, a reality that makes a judicially-invented "reasonable search" rule highly unattractive as the costs of such a rule would arguably be substantial. These costs ultimately would burden investors by diverting corporate resources to an activity not central to producing stockholder wealth. To this point, the Delaware General Corporation Law provides issuers with certainty that sending notice to an identifiable group of shareholders in a prescribed manner will satisfy its obligations to provide notice to shareholders. *See, e.g.*, 8 *Del. C.* § 262. Issuers dealing with preferred stockholders should know that an agreement specifying notice

comply with the Stockholder Agreement, when combined with its knowledge that notice was not delivered to Gildor, imposed upon it a contractual obligation to do more than it did.

Because literal compliance with § 16(g) was impossible, the key issue is what further, if anything, Optical Solutions was required to do to satisfy its notice obligations under the Stockholder Agreement. When confronted with less than literal compliance with a notice provision, courts have required that a party substantially comply with the notice provision. The requirement of substantial compliance is an attempt to avoid "harsh results . . . where the purpose of these [notice] requirements has been met."[18] When literal compliance is not possible, that is a sensible rule, and it is one which would not require Optical Solutions to search to the ends of the world for Gildor. Substantial performance is "that which, despite deviations from contract requirements, provides the important and essential benefits of the contract."[19] In this instance, substantial compliance would require that Optical Solutions take reasonable steps to provide Gildor with actual notice of the opportunity to exercise his preemptive rights.

Delaware courts have found favor with this type of substantial compliance requirement. In *Corporate Prop. Assocs. 6 v. The Hallwood Group, Inc.*, this court addressed a situation, like the one before me now, where "literal compliance with [the notice] provision would have been

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provisions will be enforced as written in the same manner that issuers know that they are required only to notify the record holders of common stock, not the beneficial owner, of certain rights in a merger. *See Enstar Corp. v. Senouf*, 535 A.2d 1351, 1354 (Del. 1987); *Gilliland v. Motorola, Inc.*, 859 A.2d 80, 85 (Del. Ch. 2004).

[18]*Colson v. Bureau of Labor and Indus.*, 831 P.2d 706, 709 (Or. Ct. App. 1992) (requiring only substantial compliance with statutory notice provisions). *See also Boe v. Edgewood, Inc.*, 425 N.W.2d 39, 1998 WL 63848, at ***3 (Wis. Ct. App. 1988) (Unpublished Disposition) ("Though Boe asserts that this [non-compliance] is fatal to Edgewood's position, we conclude that Edgewood's letter is substantial performance of the notice provision . . . ."); *Liberty Savings Bank, F.S.B. v. Laywers Title Ins. Corp.*, 1990 WL 235470, at *4 (Oh. Ct. App. Dec. 31, 1990) (stating that "there need only be a substantial and reasonable compliance with the notice provision, and not a strict literal compliance"); RICHARD A. LORD, 16 WILLISTON ON CONTRACTS § 49:109 (4th ed.) ("Notice provisions have generally been interpreted to require substantial compliance, so that notice slightly beyond the required time set by the [insurance] policy, or from one other than the insured has been held sufficient."); LEE R. RUSS, 13 COUCH ON INS. § 186:40 (2005) ("Jurisdictions differ with regard to the degree of compliance with the notice provisions of labor and material bond requirements . . . . On one hand, some jurisdictions require only substantial compliance with notice provisions."); *Williams v. Toliver*, 759 So.2d 1195, 1199 (Miss. 2000) (discussing that substantial compliance, not strict compliance, with the notice provisions of the Mississippi Tort Claims Act was required). *But see Maxson Corp. v. Gary King Constr. Co.*, 363 N.W.2d 901 (Minn. Ct. App. 1985) (requiring strict compliance with time requirement in notice provision); *Welch v. Georgia Dept. of Transp.*, 624 S.E.2d 177 (Ga. Ct. App. 2005) (requiring strict compliance with the notice provisions of the Georgia Tort Claims Act).

[19]17A AM. JUR. 2D *Contracts* 619 (2005).

impossible."[20] Vice Chancellor, now Justice, Jacobs took into account the prior conduct of the parties and determined that "the parties . . . intended that substantial compliance with the notice provision would suffice, and that, in fact, the defendant "substantially and to the extent reasonably practicable complied with the notice provision" of the relevant agreement.[21]

In another situation with similar facts, the Delaware Superior Court reached a similar conclusion. In *Beach Treat, Inc. v. New York Underwriters Ins. Co.*,[22] an insurer sent a cancellation notice to an insured in a manner that "did not adhere to the cancellation provision of the policy."[23] That cancellation notice was returned undelivered to the insurer, and the insurer opted to do nothing in light of learning that the notice was not delivered.[24] The court held that "[a]t least under the present facts, [the insurer] had a duty to make further efforts to communicate with plaintiff concerning the cancellation."[25] In that situation, which is analogous to this case, the Superior Court premised its holding heavily on the fact that the insurer departed from the terms of the policy in providing notice. In fact, the court stated that after learning the notice never reached the insured, one alternative was for the insurer to "give notice literally complying with the cancellation provisions of the policy."[26] Because Optical Solutions failed to create an address schedule for the Stockholder Agreement, making literal compliance impossible in this situation, it was bound to undertake reasonable efforts in order to substantially comply with the notice provision of the Stockholder Agreement.

One contractually-rooted method would have been for Optical Solutions to attempt notice to Gildor as if he were a subsequent holder of Stockholder Shares. Section 16(g) of the Stockholder Agreement directs Optical Solutions to notify those subsequent holders "at such address as indicated by the Company's records." Had it looked to its records, Optical Solutions would have discovered that it had more than one address on file for Gildor and that none of its recent documents had clearly indicated that any new address provided by a stockholder would supersede all prior contact information for all purposes. In addition, Gildor has pointed,

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[20]*Corporate Prop. Assocs. 6 v. The Hallwood Group Inc.*, 792 A.2d 993, 1000 (Del. Ch. 2002), *rev'd*, 817 A.2d 777 (Del. 2003). Although the Supreme Court reversed the decision on appeal, that aspect of Vice Chancellor Jacobs' opinion was not disturbed or criticized on appeal.

[21]*Id.* at 1001.

[22]301 A.2d 298 (Del. Super. 1972).

[23]*Id.* at 300.

[24]*Id.* at 301.

[25]*Id.*

[26]*Id.*

without contradiction, to record evidence that Optical Solutions had in its possession his email address, his fax number, his phone number, and the Connecticut Address. He has also pointed to evidence that he clearly provided the Connecticut Address as his "New Address of Record" when purchasing his Series D shares and again as his contact address before purchasing the Series F shares. Further, Gildor claims that Optical Solutions had used email to communicate with him on other occasions, including to notify him of the Series F financing, and could have again contacted him through email. Optical Solutions, then, could have satisfied its duty to substantially comply with the notice provision by sending Gildor notice at the Connecticut Address as well as the New York Address, or sending an email to find out where to send the notice. No heroic or even costly measures (such as employing a finder) would have been required.

Fortunately for Gildor, this case does not involve a balancing of equities, as he is not in a very sympathetic position. Gildor entrusted his brother Ephraim to serve as his financial advisor. That role involved managing Gildor's investment in Optical Solutions, which necessarily entailed Ephraim receiving communications from Optical Solutions concerning Gildor's investment. Again, as Gildor's counsel candidly conceded, Gildor and Ephraim likely meant for all notices to go to the New York Address when they provided that address to Optical Solutions in 2002. Ephraim, who served as Gildor's financial advisor in connection with his Optical Solutions investment, and specifically the purchase of the Series F shares, was negligent in failing to update his address when his business left the New York Address. In a case decided on the equities, that negligence would weigh heavily.[27]

But this is a case of Optical Solutions breaching a clear provision of the Stockholder Agreement, which was a document that it crafted unilaterally. Faced with the inability to literally comply with the Stockholder Agreement, Optical Solutions attempted to send notice to the New York Address when Optical Solutions itself had created ambiguity as to which address, the Connecticut or the New York Address, was Gildor's record address.[28] That ambiguity resulted because Optical Solutions failed to reflect anywhere that the New York Address would replace the Connecticut Address as Gildor's record address and would be used for *all* notices sent by Optical Solutions, for any purpose. Instead, Optical

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[27]In addition, when Gildor executed the Stockholder Agreement, there was no schedule containing notice addresses, and he had the opportunity to bring that fact to Optical Solutions' attention, if he was concerned with the mechanics of the notice provision.

[28]*See, e.g.*, *Kaiser Aluminum Corp. v. Matheson*, 681 A.2d 392, 398 (Del. 1996) ("It is a well-accepted principle that ambiguities in a contract should be construed against the drafter.").

Solutions was left with an address that Gildor provided as his "New Address of Record" and again in a change of address form, the Connecticut Address, and an address that Gildor provided as his mailing address in the Subscription Agreement, the New York Address. In the face of that ambiguity, rather than take low-cost steps to find Gildor such as sending notice to the Connecticut Address, Optical Solutions took no additional steps to notify him and decided to rest on its mistaken belief that it had complied literally with the Stockholder Agreement when it learned that notice did not reach Gildor at the New York Address.

Therefore, Optical Solutions failed to comply with the notice requirements of the Stockholder Agreement by sending notice to the New York Address, which was not contained in the schedules to that Agreement.[29] In light of its failure to comply and its knowledge that notice was not delivered to Gildor, Optical Solutions was required to substantially comply with the notice provision by undertaking further, reasonable efforts to notify Gildor. Instead, it did nothing, and, as a result, breached its notice obligations to Gildor in the Stockholder Agreement. Stated another way, just as issuers should be entitled to discharge their obligations to holders by providing notice in compliance with a contract as written without being subject to an implied duty to take additional efforts if the contractual form of notice fails, so must issuers who create contractual ambiguity about the method of notice bear the proportionate costs of their own drafting infelicities by undertaking reasonable efforts to provide actual notice.

B. Did Optical Solutions' Failure To Comply With The Stockholder Agreement Implicate A Fiduciary Duty To Gildor?

Aside from its contractual argument that Optical Solutions did not comply with the Stockholder Agreement, Gildor also raises a potential breach of fiduciary duty. He does so improperly because the complaint does not even assert such a cause of action.

I consider the claim to be non-existent and improperly raised now.

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[29]Gildor alternatively argues that §§ 4(a) and 4(b) require actual notice because § 4(a) states that "the Company shall first notify" certain preferred stockholders and § 4(b) states that a stockholder must "deliver a written notice from the Company to such effect within 15 business days after receipt of written notice." As to § 4(a), the "notify" language is clearly referring to the notice provision, § 16(g), which does not require actual notice. As to § 4(b), the "receipt" language does not confer upon Optical Solutions a requirement to provide actual notice but rather provides a benefit to preferred stockholders who would be notified by a method of notice, i.e., first-class mail, that would reach them later than notice provided to certain shareholders by another method, i.e., overnight courier. Starting the clock at receipt, then, evens the playing field among shareholders who receive notice via different delivery methods.

But, in order to form a complete record, I briefly will address Gildor's improperly-asserted fiduciary duty argument. In Delaware, claims made to protect or enforce a benefit inuring to a specific class of shareholders, such as a preferred stockholder, that arise from a contract are contractual in nature and do not implicate any fiduciary duty.[30] In this respect, the preemptive rights were provided to preferred stockholders owning shares of certain series of stock, and those rights arose expressly out of the Stockholder Agreement, not as a matter of equity. Because the rights Gildor seeks to enforce arose from contract, Optical Solutions' duty to give him notice was purely contractual. Therefore, Optical Solutions' was bound contractually, not by common law fiduciary duties, to notify Gildor in accordance with the Stockholder Agreement.

IV. The Remedy

As a remedy for Optical Solutions' breach of the Stockholder Agreement, Gildor seeks specific performance of his preemptive rights, which will allow him to participate in the New Issuance, or, in the alternative, a return of his entire $667,000 investment in Optical Solutions. The latter remedy is an absurd one, advanced with chutzpah, as it would turn a simple, good faith mistake by Optical Solutions into a windfall for Gildor, whose broker's lack of diligence contributed to the present hoo-ha. As the record makes clear, Gildor's original stake is now worth far less than the amount of money he invested. Therefore, the more relevant issue is whether Gildor should be entitled to purchase a stake in the New Issuance sufficient to prevent dilution of his original ownership percentage, or whether he should be remitted to the remedy of an estimation of what he lost by his exclusion from the New Issuance.

Section 16(f) of the Stockholder Agreement addresses the available remedies. That section states:

> The Company and Stockholders shall be entitled to enforce their rights under this Agreement specifically, to recover damages by reason of any breach of any provision of this Agreement and to exercise all other rights existing in their favor. The parties hereto agree and acknowledge that money damages would not be an adequate remedy for any breach of the provisions of this Agreement and that

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[30] *See In re General Motors Class H S'holders Litig.*, 734 A.2d 611, 619 (Del. Ch. 1999); *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, 1995 WL 662685, at *6 (Del. Ch. Nov. 2, 1995); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986).

> the Company and any Stockholder may in its sole discretion apply to any court of law or equity of competent jurisdiction for specific performance . . . in order to enforce or prevent any violation of the provisions of this Agreement.

Requiring Optical Solutions to honor the Stockholder Agreement by allowing Gildor to exercise his preemptive rights would be consistent with the bargain struck between Optical Solutions and its Series F stockholders.

Specific performance, of course, is a form of relief available at the discretion of this court.[31] If the Stockholder Agreement was silent as to the availability of specific performance, Gildor would bear the burden of showing that a legal remedy would be inadequate.[32] The central question in that situation would be whether a monetary award would be sufficient to remedy Gildor's inability to purchase additional Optical Solutions stock in the New Issuance. Contracts providing preemptive rights to purchase non-listed securities have given rise to specific performance orders and there is a colorable argument for that remedy here.[33] But, given Delaware's public policy of favoring freedom of contract, there is no need to make that inquiry. Section 16(f) specifically states that the parties can enforce their contractual rights by seeking specific performance and that a stockholder "may in its sole discretion apply to any court of law or equity of competent jurisdiction for specific performance . . . in order to enforce or prevent any violation of the provisions of this Agreement." Although this court has not had the prior opportunity to determine whether a contractual provision granting an aggrieved party a contractual right of specific performance is

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[31]*See, e.g.*, *Marvel v. Conte*, 1978 WL 8409, at *4 (Del. Ch. Oct. 24, 1978); *Esso Standard Oil Co. v. Cunningham*, 114 A.2d 380, 383 (Del. Ch. 1955).

[32]*See Lineberger v. Welsh*, 290 A.2d 847, 848 (Del. Ch. 1972) ("Whether the subject matter of a contract is real or personal property, the test for availability of the remedy of specific performance is inadequacy of the remedy at law."); DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 12-3 (2005) ("The quintessential guidepost for availability of specific performance, therefore, is inadequacy of the remedy at law.").

[33]This court has recognized that specific performance of a stock purchase is appropriate in situations where the stock is not available in the market, is unique, or has unique value to the purchaser. *See, e.g.*, *Amaysing Tech. Corp. v. Cyberair Commc'ns, Inc.*, 2004 WL 1192602, at *3 (Del. Ch. May 28, 2004); *Hazen v. Miller*, 1991 WL 244240, at *5-6 (Del. Ch. Nov. 18, 1991). Here, the stock was not available in the market, as Optical Solutions was a small private company, and the preemptive rights gave Gildor the right to maintain his proportional share of the upside of a start-up firm. Due to the remedy provision of the Stockholder Agreement, though, I need not determine whether the specific nature of Optical Solutions' stock would warrant specific performance in the absence of that provision.

enforceable,[34] Delaware courts do not lightly trump the freedom to contract and, in the absence of some countervailing public policy interest, courts should respect the parties' bargain.

Indeed, in the analogous context of a party seeking a preliminary injunction, this court has held that a contractual stipulation of irreparable harm is sufficient to demonstrate irreparable harm.[35] This court, in *Kansas City Southern v. Grupo*, held that as long as the parties did not include the irreparable harm stipulation as a sham, i.e., when an adequate remedy at law clearly exists, or simply as a means to confer jurisdiction on this court, then the stipulation will be upheld.[36] It would create an odd kink in Delaware law, then, to determine that parties are permitted to stipulate by contract that a breach will give rise to irreparable harm but not to stipulate that an aggrieved party may obtain specific performance as a remedy for breach. Here, Optical Solutions' breach prevented Gildor from exercising his preemptive right to buy additional preferred stock. That breach arguably would warrant specific performance even in the absence of a contractual authorization for that remedy, but specific performance, in this case, is warranted because Optical Solutions breached the Stockholder Agreement, and the parties stipulated in § 16(f) that an aggrieved stockholder could petition a court for specific performance in order to enforce provisions in the Stockholder Agreement.

V. Conclusion

For the foregoing reasons, Gildor's motion for summary judgment is GRANTED, and Optical Solutions' motion for summary judgment is DENIED. The parties shall confer and craft an order of specific

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[34]WOLFE & PITTENGER § 12-3 ("Given the requirement that the applicant demonstrate the inadequacy of the legal remedy as a precondition to obtaining specific performance of a contract as well as the discretionary nature of that form of relief, discussion is warranted regarding the extent to which the Court of Chancery will defer to a contract provision stipulating that any breach of the contract necessarily constitutes irreparable harm rendering the legal remedy inadequate. Such provisions are commonplace in modern commercial agreements. Yet there is little Delaware law touching on the enforceability or effect of such provisions in the context of a request for specific performance.").

[35]*See Kansas City Southern v. Grupo TMM, S.A.*, 2003 WL 22659332, at *5 (Del. Ch. Nov. 4, 2003); *Cirrus Holding Co. Ltd. v. Cirrus Indus., Inc.*, 794 A.2d 1191, 1209-10 (Del. Ch. 2001); *True North Commc'ns, Inc. v. Publicis S.A.*, 711 A.2d 34, 44 (Del. Ch. 1997), aff'd, 705 A.2d 244 (Del. 1997); *see also* WOLFE & PITTENGER § 12-3 ("In the context of applications for interim injunctive relief, the Court of Chancery consistently has held that contractual stipulations of irreparable injury resulting from breach are sufficient in and of themselves to establish the element of irreparable harm . . . . One may suspect that the Court will take a similar approach when considering whether to specifically enforce a contract containing such a provision.").

[36]*See Kansas City Southern*, 2003 WL 22659332, at *5.

performance, working together cooperatively to address any practicability problems.

LEVY v. HAYES LEMMERZ INTERNATIONAL, INC.

No. 1395-N

Court of Chancery of the State of Delaware, New Castle

April 5, 2006

Joel Friedlander, Esquire, of Bouchard Margules & Friedlander, Wilmington, Delaware; and Michael I. Allen, Esquire, Yoram J. Miller, Esquire, and Jason C. Vigna, Esquire, of Shapiro Forman Allen Sava & McPherson, New York, New York, of counsel, for plaintiffs.

Rolin P. Bissell, Esquire, John J. Paschetto, Esquire, and Michele Sherretta, Esquire, of Young Conaway Stargatt & Taylor, Wilmington, Delaware, for defendants.

LAMB, *Vice Chancellor*

The plaintiffs in this case, former outside directors of a public company engaged in the automobile supply trade, were sued by both stockholders and bondholders of that company for various statutory violations and breaches of fiduciary duty when the company was forced to reveal that its financial statements for the years 1999-2001 contained materially misleading information. In May 2005, those former directors settled the claims against them for $27.5 million, paying $7.2 million of that sum out of their own pockets.

The corporation which the plaintiffs served entered Chapter 11 bankruptcy in 2001, and emerged two years later as the operating subsidiary of a new entity. When the plaintiffs sought indemnification for the settlement amount under the old corporation's bylaws, under their individual indemnification agreements, and under the bankruptcy reorganization plan, both the old company and the new holding company

refused. In response, the directors filed this suit on June 3, 2005, seeking an order requiring both the old and new companies to indemnify them for their settlement expenses. The defendants moved to dismiss that action pursuant to Court of Chancery Rule 12(b)(6). After the plaintiffs amended their complaint on September 29, 2005, the defendants renewed their motion to dismiss or alternatively to stay the plaintiff's indemnification actions until the claimants satisfy various procedural hurdles the companies claim are required. The court heard argument on that motion on February 6, 2006.

In this opinion, the court dismisses the plaintiffs' claims as to the new holding company, which the court finds as a matter of law has no obligation to indemnify its predecessors' former directors and officers. However, the court denies the motion to dismiss as to the old company because the court finds that the directors have a right to proceed with their claim for indemnification at this time.

The amounts sought by these former outside directors are certainly large. But the size of the settlement payments does not lessen the duty of the current directors to make a good faith judgment as to whether the putative indemnitees are entitled to be indemnified by the corporation for the amounts they were required to pay to settle the actions arising out of the company's financial restatement.

I.

A. The Parties

Throughout all relevant periods, Hayes Lemmerz International, Inc., referred to in this opinion as "Old Hayes," was a publicly traded manufacturer of wheels and other auto parts. As described in greater detail below, Old Hayes entered into bankruptcy in December of 2001. After the company emerged from that reorganization on June 3, 2003, the business of Old Hayes, now an operating subsidiary, was carried forward by a successor company also called Hayes Lemmerz International, Inc., referred to in this opinion as "New Hayes." Both Old and New Hayes are defendants in this action.

The plaintiffs in this case, Paul S. Levy, Jeffrey Lightcap, David Y. Ying, Anthony Grillo, Cleveland Christophe, and Ray H. Witt, are all former outside directors of Old Hayes. Christophe and Levy served on the Old Hayes board of directors from 1996 to 2003. Lightcap and Ying served on the board from 1997 to 2003. Witt served on the board from 1999 to June 2001, and Grillo served from 1999 to July 2001.

B. The Facts[1]

1. Accounting Irregularities And The Class Actions Against Old Hayes

On August 9, 2001, the chief executive officer of Old Hayes brought certain potentially troublesome accounting issues to the attention of the board of directors,[2] which quickly authorized a full investigation by the law firm of Skadden, Arps, Slate, Meagher & Flom LLP and the accountants Ernst & Young, LLP. Over the ensuing weeks, the investigating team conducted extensive interviews, reviewed many documents, and reported to the audit committee and to the Old Hayes board.

While this investigation was ongoing, Old Hayes publicly announced its audit committee's conclusion that the company's reported financial results for fiscal year 2000 and the first quarter of 2001 were incorrect and would have to be restated. The next day, September 6, 2001, Helen Korinsky sued Old Hayes, its executive officers, its outside directors, and certain other defendants, alleging that various of those parties violated Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act and the regulations promulgated thereunder. That action and several others filed by Old Hayes stockholders were consolidated into a single case captioned *In re Hayes Lemmerz International, Inc. Equity Securities Litigation*,[3] seeking in excess of $50 million in damages and other relief related to the decline in the price of the company's equity securities following the announced restatement.

On December 13, 2001, Old Hayes issued another press release announcing that the restatement process was substantially complete, and the company had concluded that its financial results for the fiscal year 1999, including the related quarterly periods, would also have to be restated. On May 4, 2002, Pacholder High Yield Fund, Inc. sued Old Hayes's executive officers, its current and former directors (including all the plaintiffs in this case), Hayes's auditors, and the underwriters of Hayes's 1999 through 2001 bond offerings on behalf of itself and others similarly situated, alleging that in connection with the misstated financials those parties violated various sections of the securities laws. The plaintiffs in

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[1]The facts recited in this opinion are taken from the well-pleaded allegations of the Amended Complaint ("Compl."), unless otherwise noted, and are presumed to be true for the purposes of this motion.

[2]Compl. ¶ 21.

[3]No. 01-CV-73433 (E.D. Mich. Sept. 6, 2001).

this so-called bondholder action, captioned *Pacholder High Yield Fund, Inc. v. Cucuz*,[4] sought several hundred million dollars in damages and other relief related to the decline in the price of the company's debt securities after the company announced its restatements. The two class actions, namely the stockholder action first filed by Korinsky and the Pacholder bondholder action, were consolidated for pre-trial purposes on February 19, 2004.

2. The Old Hayes Bankruptcy

On December 15, 2001, Old Hayes filed a petition in the United States Bankruptcy Court for the District of Delaware for protection pursuant to Chapter 11 of the United States bankruptcy code. As part of this process, Old Hayes negotiated with its stakeholders to fashion its reorganization plan, which was approved by the bankruptcy court on May 12, 2003.

In part, the reorganization plan excluded the former directors of Old Hayes from any release of Old Hayes's indemnification obligations in the bankruptcy, but capped those potential obligations at $10 million beyond the amount paid pursuant to Old Hayes's directors and officers ("D&O") insurance policies. Section 11.7 of the reorganization plan stated, in relevant part:

> (a) Except as specifically provided in Section 6.7 of the Plan, in satisfaction and compromise of the Indemnitee's Indemnification Rights, all Indemnification Rights except those held by (i) Persons included in either the definition of "Directors and Officers" or the "Insureds" in either of the policies providing the Debtors' D&O Insurance as of December 15, 2002 . . . shall be released and discharged on and as of the Effective Date.
>
> (b) On and after the Effective Date, the Indemnification Rights excepted from the release and discharge (i) shall remain in full force and effect . . . and shall not be modified in any way by the Chapter 11 Cases . . . (ii) shall be limited to the coverage provided in the Debtors' D&O Insurance as of December 15, 2002 and any additional Insurance Coverage purchased pursuant to Section 11.7

[4]No. 02-CV-71778 (E.D. Mich. May 4, 2002).

> plus an additional $10 million in the aggregate with respect to the directors of [Old Hayes] who serve on the executive committee of [Old Hayes's] board of directors serving in such capacity . . . and the Reorganized Debtors shall not be liable to make any payments beyond the additional $10 million in excess of any such coverage actually paid by the D&O Insurance or the Insurance Coverage to or for the benefit of any such Indemnitee . . . .[5]

The plain language of the reorganization plan mandates that "Reorganized Debtors" under this provision includes Old Hayes as well as what would become the new holding company for the Hayes auto parts business, New Hayes. The complaint alleges that this provision extends liability for indemnification to both Old and New Hayes.

Old Hayes emerged from bankruptcy on June 3, 2003 and began operating as a wholly owned subsidiary of New Hayes. On or before February 27, 2002, however, the Securities and Exchange Commission began an investigation into the misstated financials, which is still pending. In June 2005, the company and certain former officers of Old Hayes received Wells Notices from the SEC indicating that the SEC intended to recommend enforcement action against them. None of the plaintiffs in this case, however, has ever received a Wells Notice or any other indication that he is a target of that SEC investigation.

3. The Class Action Settlement

On May 2, 2005, Old Hayes's D&O insurance carriers, the outside directors, and the class action plaintiffs, agreed to settle all outstanding claims against the outside directors for $27.5 million. Old Hayes's insurers, Gulf Insurance Company and Continental Casualty Company, agreed to fund $20.3 million of this sum, apparently exhausting the Gulf D&O policy, but expressly leaving certain amounts of the Continental policy untapped.[6] The outside directors personally funded the remaining $7.2 million, which was deposited into an escrow account controlled by counsel for the class action plaintiffs on June 1, 2005.

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[5]Compl. ¶ 36.

[6]This information was provided by the defendants as an exhibit to their opening brief to dismiss or stay the amended complaint, and is therefore outside the strict bounds of what the court may consider in a 12(b)(6) motion. Defs.' Opening Br. Ex. B. The court does not rely on this information for any of its conclusions, but nonetheless includes it for the sake of completeness.

4. The Plaintiffs' Demand For Indemnification

In connection with that payment, the outside directors sought indemnification from both Old Hayes and New Hayes pursuant to their indemnification rights under the Old Hayes bylaws,[7] their indemnification agreements with Old Hayes, and what they believe to be their rights under Section 11.7 of the reorganization plan. The New Hayes board of directors met on or about April 29, 2005 allegedly to consider the outside directors' demand for indemnification. Also in attendance at this meeting was the one remaining director of Old Hayes. During the evening of May 26, 2005, the outside directors were allegedly informed by representatives of both New and Old Hayes that the companies would not indemnify any of the outside directors for the cost of settling the bondholder and stockholder class actions.[8] In response to that refusal, the outside directors filed their initial complaint in this case on June 3, 2005, without making any written demand on the boards of either Old or New Hayes.

On September 13, 2005, however, the outside directors sent a letter to the defendants reiterating their demand for indemnification.[9] Old Hayes responded to this letter on September 26, 2005, "urg[ing] plaintiffs to abandon [their] improper litigation strategy" and refusing to indemnify the plaintiffs until they agreed "to follow the procedures set forth in the Indemnification Agreements."[10] The letter went on to request a wide range of information from the plaintiffs, purportedly to allow Old Hayes to make what the letter called an "informed decision" regarding the plaintiffs'

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[7]The relevant Old Hayes bylaw provides that "the Corporation shall indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, or investigative . . . by reason of the fact that he is or was a director or officer of the Corporation . . . against expenses . . . actually and reasonably incurred by him in connection with such action, suit, or proceeding if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Corporation . . . ." Pls.' Opposition to Defs.' Mot. To Dismiss Ex. A.

[8]Compl. at ¶ 48.

[9]This letter explained that the plaintiffs did not believe that they were required to make written demand, but that they had done so nonetheless: "Under these circumstances, we do not believe that any further action, including providing Old or New Hayes with a written demand for indemnification, is required of the Directors prior to filing a complaint against Old Hayes and/or New Hayes. Quite simply, it is our position that if any further demand was necessary prior to the filing of a complaint, such an act was excused by Old Hayes' and/or New Hayes' anticipatory breach of their obligation to indemnify the Directors . . . . Nevertheless, and without waiver of any of the Directors' rights and their arguments, we hereby demand on behalf of the Directors of Old Hayes that Old Hayes and/or New Hayes indemnify the Directors for the cost of the Settlement, plus interest from the date that payment was made, plus costs and attorneys fees incurred in connection with their enforcement of their rights to indemnification." Compl. Ex. 8.

[10]*Id.*

demand.[11] In response to these communications, the plaintiffs filed the amended complaint on September 29, 2005.

II.

A. The Plaintiffs' Allegations

Count I of the amended complaint seeks monetary damages resulting from the company's refusal to honor its agreements to indemnify the plaintiffs with respect to the settlement of the class action suits. The plaintiffs allege that they are due these expenses, which comprise not only the $7.2 million paid in connection with the settlement, but also interest, expenses, and attorneys' fees, including the costs and expenses incurred in connection with the current action, from both Old and New Hayes pursuant to the Old Hayes bylaws, the plaintiffs' indemnification agreements, and the bankruptcy reorganization plan.

Count II seeks a declaration that the plaintiffs are entitled to be indemnified by the companies in an amount up to $10 million beyond any amount actually paid under the D&O policies for the benefit of the outside directors in connection with the May 2, 2005 settlement and related costs. In other words, this count seeks to assure the plaintiffs that they will be indemnified not only for the $7.2 million plus costs already incurred, but also for any additional liability up to the full $10 million cap provided for by the reorganization agreement.

B. The Defendants' Motion To Dismiss

The defendants have moved to dismiss both counts of the plaintiffs' complaint on a number of grounds. First, the defendants argue that all counts against New Hayes should be dismissed because the plaintiffs were never directors of New Hayes, and because New Hayes has no obligation, by contract or otherwise, to indemnify the plaintiffs. Particularly, the defendants argue that Section 11.7 of the reorganization plan, which limits New Hayes's liability for indemnification over D&O insurance to $10 million, does not, as the plaintiffs claim, implicitly extend Old Hayes's indemnification obligations to New Hayes.

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[11]The defendants' information demand, attached to the September 26, 2005 letter, includes 25 categories of documents, some of which seem quite broad on their face. Category 8, for example, requests "all documents that reflect, evidence, constitute, or refer to the actual or potential liability of any of Plaintiffs for actions taken in his capacity as a director of Old-Hayes." Compl. Ex. 8. Clearly, this request could potentially require an enormous amount of document production.

Second, the defendants move to dismiss the complaint against both Old and New Hayes because, they argue, the plaintiffs have breached their indemnification agreements. In short, the defendants claim that the indemnification agreements contain certain procedural requirements that are prerequisites to any legitimate claim for indemnification. Because the plaintiffs have failed to overcome these procedural hurdles, and most importantly have failed to allow the defendants 30 days after the first written demand to respond, the defendants claim that the amended complaint is premature.

Finally, the defendants argue that their statutorily required determination of whether the plaintiffs have met the "good faith" and "best interests" tests of Section 145 cannot be made until after the conclusion of the pending SEC investigation. Therefore, they argue, the complaint betrays a rush to judgment on the part of the plaintiffs, and should be stayed until all the relevant facts have been collected, and until the defendants can be sure that no SEC investigation is forthcoming against any of the plaintiffs.

III.

This case has come before the court on a motion to dismiss under Court of Chancery Rule 12(b)(6). Generally speaking, a court may only grant such a motion if it can "determine with reasonable certainty that, under any set of facts that could be proven to support the claims asserted, the plaintiffs would not be entitled to relief."[12] Currently, this case primarily concerns the interpretation of written agreements. Thus, the court will only grant the motion to dismiss in favor of the defendants if those written agreements may only be reasonably read in the manner advanced by New and Old Hayes. If, however, those agreements can reasonably be read in more than one way, the motion to dismiss must be denied.[13]

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[12]*Grobow v. Perot*, 539 A.2d 180, 187 n.6 (Del. 1988).

[13]*See VLIW Tech., LLC v. Hewlett-Packard Co.*, 840 A.2d 606, 614-615 (Del. 2003) ("In deciding a motion to dismiss, the trial court cannot choose between two differing reasonable interpretations of ambiguous provisions. Dismissal, pursuant to Rule 12(b)(6), is proper only if the defendants' interpretation is the only reasonable construction as a matter of law.").

IV.

A. The Indemnification Liability Of New Hayes To The Outside Directors

The defendants argue that all counts against New Hayes should be dismissed because the plaintiffs were never directors of New Hayes, and because no provision of any agreement, and particularly not Section 11.7 of the reorganization plan, requires New Hayes to extend indemnification to Old Hayes's directors. The plaintiffs' response is simple. Because Section 11.7 limits both Old Hayes's and New Hayes's liabilities, it necessarily implies that New Hayes is also bound by Old Hayes's obligation to indemnify its directors.

First, as the plaintiffs implicitly concede, the outside directors have no direct basis to claim that they are indemnified by New Hayes. That is to say, they never were directors of New Hayes, and never signed indemnification agreements with that entity. Their argument depends, therefore, on their reading of Section 11.7 of the reorganization agreements, under which the plaintiffs believe New Hayes assumed the indemnification obligations in question.

The plaintiffs' proposed reading of that unambiguous provision, however, is plainly unreasonable. First, the reorganization plan makes clear that the court is not to assign liabilities to New Hayes by implication. Specifically, the reorganization plan provides that New Hayes would assume only those obligations of Old Hayes that it *expressly* assumed. Section 4.14 states:

> Except to the extent a Reorganized Debtor expressly assumes an obligation or liability of a Debtor, or another Reorganized Debtor, the Plan will not operate to impose liability on any Reorganized Debtor for the claims against any other Debtor or the debts and obligations of any Debtor or Reorganized Debtor . . . .[14]

In similar cases, and faced with similar language, our courts have required plaintiffs seeking indemnification to point to specific contractual language that actively assigns liability to the new, successor, defendant.[15]

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[14]Compl. Ex. 1 at A-47.

[15]In discussing the responsibilities of a successor corporation to indemnify a former director, for example, this court has held that liability for indemnification was assumed by the successor as a contractual matter when the merger agreement in question expressly mandated that

Section 11.7, however, provides no such clear mandate. Indeed, at its most basic, the question of New Hayes's liability is determined by the fact that the provision in question says nothing affirmatively about its obligations. Rather, it provides only that any liability for indemnification, to the extent it exists, is capped at $10 million above Old Hayes's D&O policies. Significantly, the sophisticated bankruptcy parties knew quite well how to negotiate for a provision that expressly assigned liability to New Hayes, as evidenced by other, unambiguous, provisions of the reorganization agreement. Section 6.7, for example, requires both New and Old Hayes to continue the company's pension plans:

> Upon the occurrence of the Effective Date, the Reorganized Debtors shall continue the Pension Plan, meet the minimum funding standards under ERISA and the Internal Revenue Code, . . . and administer and operate the Pension Plan in accordance with its terms and ERISA.[16]

Similarly, Section 6.8 imposes the same duties in terms of the company's workers' compensation plan:

> Upon confirmation and substantial consummation of the Plan, the Reorganizing Debtors shall continue the Worker's Compensation Programs in accordance with applicable state laws . . . .The Reorganized Debtors shall be responsible for all valid claims for benefits and liabilities under the Workers' Compensation Programs regardless of when the applicable injuries were incurred.[17]

The distinction between these provisions and Section 11.7, which pointedly includes no "shall" clause as to New Hayes other than providing that whatever its liabilities they are not to exceed $10 million above the insurance, is striking. If the reorganization plan was meant to ensure that New Hayes would be responsible for indemnification, the drafters could easily have used the template provided by the rest of the reorganization agreement to reach that result. They did not do so. Thus, there is no reason to believe that Section 11.7 acts as anything other than a limitation on the

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both parties "shall indemnify to the fullest extent permitted under [Delaware law] the former directors and officers "of the selling party. *Chamison v. Healthtrust, Inc.*, 735 A.2d 912, 919-20 (Del. Ch. 1999).

[16]Compl. Ex. 1 at A-53.

[17]*Id.* at A-55.

Reorganized Debtors' liability, as dictated by its plain contractual language.[18] Counts I and II against New Hayes must be dismissed.

B. The Procedural Structure Of The Outside Directors' Indemnification Rights

The only remaining claims for indemnification, therefore, are against Old Hayes, by virtue of the plaintiffs' indemnification agreements with that company, as authorized by the Old Hayes bylaws. In connection with those claims, the defendants argue that, whatever the plaintiffs' eventual right to indemnification, their case to compel payment is premature because they have failed to satisfy certain threshold contractual provisions of the indemnification agreements. This argument is in part dependent on the way that the defendants interpret the following language in Section 2(a) of the indemnification agreements:

> In the event Indemnitee was, or becomes a party to . . . a Claim by reason of (or arising in part out of) an Indemnifiable Event, the Company shall indemnify Indemnitee to the fullest extent permitted by law as soon as practicable, but in any event no later than thirty days after written demand is presented to the Company.

In the defendants' view, this provision only makes sense if read to extend "the thought . . . beyond the word 'practicable' to include the phrase 'after

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[18]The court recognizes that this reading of the reorganization plan means that the directors' indemnification agreements are now guaranteed not by a publicly traded corporation, but by its wholly owned subsidiary. This is significant, in the plaintiffs' view, because Section 11.7(b)(i) of the reorganization plan provides that those rights "shall not be modified, reduced, discharged, or otherwise affected" by the reorganization other than as provided for in the rest of Section 11.7. Because the shift of Old Hayes from a public company to a subsidiary would modify the plaintiffs' expectations, the outside directors believe that the agreement should be read to preserve the plaintiffs' rights to payment from a public corporation, and thus to extend liability to New Hayes. This, simply, is not a reasonable reading of Section 11.7(b)(i). The plaintiffs' rights to indemnification are exactly as they were before the reorganization plan. Far from implying that liability is imposed on New Hayes, the only reasonable reading of Section 11.7(b)(i) is that it exists to address exactly the concern that the plaintiffs raise; under that provision, the plaintiffs can be secure in their belief that the only change to their rights is that they are capped at $10 million beyond the D&O insurance. If the parties meant to impose liability on New Hayes, they were required to do so expressly. This court will not look to extrinsic evidence when the reorganization agreement's meaning is otherwise so evident. *James River-Pennington Inc. v. CRSS Capital Inc.*, 1995 Del. Ch. LEXIS 22, *14 (Del. Ch. Mar. 6, 1995) ("a trial court may not consider parol evidence when interpreting a clear and unambiguous contract").

written demand is presented to the Company.'"[19] Read in that way, the defendants argue that Section 2(a) establishes a strict demand regime for any indemnification claim. First, any potential indemnitee must make a written demand on the company. That written demand, and nothing else, triggers a thirty-day period in which the company can consider the indemnitee's request.

Under that reasoning, the plaintiffs officially initiated indemnification proceedings by presenting written demand on September 13, and not by their informal request on May 26. By filing their amended complaint only 16 days afterwards, the plaintiffs therefore deprived the company of its contractually mandated thirty-day consideration period, violated the procedural requirements of the indemnification agreements, and thus repudiated their rights to indemnification.[20]

The defendants' arguments as to the procedural structure of Section 2(a) clearly find their foundation in the Supreme Court's decision in *Stifel Financial Corp. v. Cochran*.[21] There, a corporation resisting an indemnification claim argued that the directors' authority to decide an indemnitee's rights to payment under 8 *Del. C.* § 145 meant that any indemnitee must make demand on the corporation before pressing his claim. The court rejected that analogy to the board of directors' power over derivative litigation or books and records actions under 8 *Del. C.* § 220, noting that the statutory nature of indemnification precluded the court from implying procedural safeguards that the legislature could itself have expressly included:

> The General Assembly has spoken on the issue, and in the absence of a specific legislative restriction, we cannot engraft a requirement that creates a further bar to a

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[19]Defs.' Reply Br. 15.

[20]The defendants also apparently believe that Section 2(b) provides a second, independent, limitation on an indemnitiee's right to sue before the company has issued a formal rejection of the directors' claims, based on language which requires that "if there has been no determination by the Reviewing Party or if the Reviewing Party determines that Indemnitee substantively would not be permitted to be indemnified . . . Indemnitee shall have the right to commence litigation . . . ." Compl. Ex. 2 at § 2(b). Because the defendants maintain on the basis of their equivocal September 26 letter that they have not actually refused to indemnify the plaintiffs, but have only made procedural objections to the plaintiffs' strategy in pursuing their rights, they claim that Section 2(b) strengthens their position on this motion to dismiss because the plaintiffs' right to commence litigation has not yet ripened. Like Old Hayes's principal argument, this subsidiary claim is unsupported by an unambiguous reading of the contract language.

[21]809 A.2d 555 (Del. 2002).

statutorily created remedy.[22]

The court then went on to note, however, that there was no impediment in Delaware law if a corporation itself contracted for expanded procedures: "[F]inally, we note that Stifel was free to write a demand requirement into its bylaws, but did not."[23]

The defendants' claim, therefore, is that Section 2(a) of the indemnification agreements represents exactly the kind of expanded procedural structure, for the benefit of the indemnifying company, approved in *Stifel*. While the court stands ready to enforce such demand requirements when presented, the plain language of these indemnification agreements does not appear to support the defendants' proposed interpretation.[24]

There is no indication that the indemnification provision requires the plaintiffs in this case to issue a written demand on Old Hayes.[25] The most likely interpretation of the disputed provision, in fact, is precisely the one the plaintiffs have presented, that Section 2(a) of the indemnification provision protects the potential indemnitee by requiring Old Hayes to

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[22]*Id.* at 560.

[23]*Id.*

[24]In reaching this conclusion, however, the court rejects the plaintiffs' argument that the Old Hayes bylaws and the indemnification agreements provide two entirely independent sources of indemnification, and that therefore any procedural requirements for indemnification under the agreements are irrelevant to indemnification under the bylaws. Not only does such a construction of the two documents make nonsense of the indemnification agreements, but it is plainly contradicted by our cases. Most obviously, the Supreme Court was confronted with a similar situation in *Citadel Holding Corp. v. Roven*, 603 A.2d 818 (Del. 1992), where a bylaw provided indemnitees with the full range of indemnification rights available under Delaware law, and the accompanying indemnification agreement contained certain other rights. The court there assumed that the two documents would be read together, and firmly rejected the defendant's position that the indemnification agreement somehow left the advancement provision, at issue in that case, entirely unchanged. The court sees no reason to read the plainly conjunctive documents in this case any differently than the Supreme Court construed them in *Citadel*.

[25]The defendants rely, in part, on the authority of R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS, §§ 4.24, 4.26 (3d ed. Supp. 2006) for their argument that corporations commonly contract to limit the rights of directors to demand indemnification. The sections of that treatise selectively excerpted in their papers, however, prove exactly the opposite point. Section 4.24, for example, explains that "the determination procedure may be critical in many indemnification cases, particularly where there has been a change of control or insolvency. To provide *an additional measure of protection to directors*, many corporations are entering into definitive and comprehensive agreements providing clear indemnification rights, procedures, and presumptions . . . ." *Id.* at § 4.24 (emphasis added). Similarly, Section 4.26 notes that "Section 145(f) may authorize the adoption of various procedures . . . to make the process of indemnification *more favorable* to the indemnitee without violating the statute. For example, such agreements or bylaws could provide for . . . (iii) *accelerated proceedings for the 'determination'* required by Section 145(d) to be made in the specific case." *Id.* at § 4.26 (emphasis added).

respond to a request for indemnification "as soon as practicable," and also by allowing the plaintiffs to put Old Hayes on the clock by issuing a written demand.

This interpretation, if supported at trial, would be logically consistent with the way our courts have interpreted similar indemnification agreements in the past. In *Citadel Holding Corp. v. Roven*,[26] the Supreme Court was asked to decide whether an indemnification agreement provided greater rights to advancement than did the corporation's bylaws. Relying on preliminary recitals in the indemnification agreement which explained that the indemnitee "does not regard the indemnities available under the Corporation's Certificate of Incorporation and Bylaws and available insurance, if any, as adequate to protect him against the risks associated with his service to the Corporation[,]"[27] the Supreme Court held that the purpose of the agreement was to provide the director with "greater protection than he already enjoyed under the Certificate of Incorporation, Bylaws, and insurance provided by [the corporation]."[28] The court therefore interpreted the agreement consistently with that purpose.

The recitals in the indemnification agreements *sub judice* similarly avow their intent to protect the plaintiffs:

> Whereas, in recognition of Indemnitiee's need for substantial protection against personal liability in order to enhance Indemnitiee's service to the Company in an effective manner, the increasing difficulty in obtaining satisfactory director liability insurance coverage and Indemnitiee's reliance on the aforesaid Charter and By-Laws . . . the Company wishes to provide in this Agreement for the indemnification of and the advancing of expenses to Indemnitee to the fullest extent permitted by law.[29]

Section 2(a) can thus most reasonably be read in the same way—in favor of indemnitees—as the agreement in *Citadel*. In contrast, nothing in the indemnification agreements suggests any countervailing intent, or that the agreements were drafted with the intention to create procedural protections for Old Hayes.

Further, unlike the plaintiffs' proposed reading, which is consistent

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[26]603 A.2d at 818.
[27]*Id.* at 819.
[28]*Id.* at 823.
[29]Compl. Ex. 2.

with the indemnification agreements and with Delaware law, Old Hayes's rewriting of Section 2(a) to include a purportedly dropped comma introduces a complexity for which there is no obvious justification. Contrary to the defendants' assertion, for example, our courts have had no trouble interpreting the phrase "as soon as practicable," even without an accompanying temporal limitation.[30] Nor do the agreements, on their face, evidence the kind of "sloppiness" that our law has suggested requires the court to redraft a contract in accordance with the manifest intent of the parties.[31] If anything, the contract as drafted exactly follows the parties' intent, to the extent it is evident from the complaint. In that context, it would be quite extraordinary for this court to determine on a motion to dismiss that a contract intended on its face to favor the plaintiffs included a demand requirement that would operate to hamper their rights to indemnification. Taking all facts pleaded by the plaintiffs as true, therefore, the court finds that Section 2(a) of the indemnification agreements is clear that no prior written demand for indemnification is required.

C. The Duty Of Good Faith And Fair Dealing

Independently, the defendants maintain that the plaintiffs violated their implied duties to perform the indemnification agreements with good faith and fair dealing when they refused to respond to Old Hayes's September 26 document requests. Thus, the defendants argue, the plaintiffs are owed no performance under those agreements at this time.

Certainly, the omnipresent responsibilities of good faith and fair dealing underlie the indemnification agreements,[32] as they underlie all

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[30] *Oberly v. Kirby*, 592 A.2d 445, 464 (Del. 1991) ("The Certificate clearly requires that there be at least three members at all times and that vacancies be filled 'as soon as practicable.' We find no merit in Fred's contention that he could not decide who was best qualified to serve the Foundation and therefore did not find it 'practicable' to appoint new members. Given the mandatory language of the Certificate, eleven years was clearly too long to delay in performing his duty as the sole member."); *AGR Halifax Fund v. Fiscina*, 743 A.2d 1188, 1197 (Del. Ch. 1999) (holding that a delay of one month in producing certain documents did not constitute a contractual failure to produce documents "as soon as practicable.").

[31] *Interim Healthcare v. Spherion Corp.*, 884 A.2d 513, 555 (Del. Super. 2005). Even if the contractual language is in error, this is clearly not an issue suited for disposition under Rule 12(b)(6). In *Interim Healthcare*, for example, the court reached its conclusion to clarify contractual language *after trial*. *Id.* at 555.

[32] This court has, on several occasions, recognized that the implied covenant of good faith and fair dealing is an implicit part of an indemnification agreement, and has left questions of those implied duties for determination at trial. *Chamison*, 735 A.2d at 921-22 (holding that an indemnitiee's refusal of a defendant's choice of counsel under an indemnification agreement was justified by the evidence adduced at trial because the defendant violated the implied duties of good

Delaware contracts.[33] As the Supreme Court summarized the relevant law,

> [T]he implied covenant requires "a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain." Thus, parties are liable for breaching the covenant when their conduct frustrates the "overarching purpose" of the contract by taking advantage of their position to control implementation of the covenant's terms.[34]

Thus, the court assumes that a contracting party can indeed violate the covenant of good faith and fair dealing in an indemnification agreement by withholding information. Of course, an implied covenant would be an extremely curious way for sophisticated parties to structure the exchange of key documents, but a contract's inelegance does not make it implausible.[35] Nor does the fact that Old Hayes itself seems best situated to possess the key documents completely preclude liability under this theory.

At this early stage in the litigation, however, the court can only take into account the facts as pleaded in the complaint. The complaint and the accompanying documents show only that certain, unspecified, documents were requested by Old Hayes, that some of them may already be in Old Hayes's possession, and that Old Hayes had in any case already decided not to indemnify the plaintiffs when the request was made.[36] Nothing in, or

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faith and fair dealing by insisting on inadequate counsel); *Tafeen v. Homestore Inc.*, 2004 Del. Ch. LEXIS 156, *8-9 (Del. Ch. Oct. 27, 2004), *aff'd*, 888 A.2d 204 (Del. 2005) (holding, after trial, that a director who was granted advancement, but maintained an extravagant personal lifestyle, did not violate any duty under the implied covenant of good faith and fair dealing to maintain and demonstrate a financial ability to repay that advancement if unsuccessful at the indemnification stage); *Greco v. Columbia/HCA Healthcare Corp.*, 1999 Del. Ch. LEXIS 24, *22-23 (Del. Ch. Feb. 11, 1999) (holding that an indemnitee did not violate his implied duties of good faith and fair dealing by failing to inform the defendants that he was seeking advice from a third party attorney who was acting adversely to the defendants in another action).

[33]*Dunlap v. State Farm Fire and Cas. Co.*, 878 A.2d 434 (Del. 2005).

[34]*Id.* at 442.

[35]*E.g.*, *Bonham v. HBW Holdings*, 2005 Del. Ch. LEXIS 210, *33-34 (Del. Ch. Dec. 23, 2005) ("[T]he implied duty of good faith cannot be used to create a 'free-floating duty . . . unattached to the underlying legal document."); *Tafeen*, 2004 Del. Ch. LEXIS at *8 (noting, in the context of an indemnification agreement that "it would be odd for the court to interpret Homestore's bylaws as impliedly obligating Tafeen to maintain and demonstrate financial ability to repay when the express terms of Homestore's bylaws do not require a secured undertaking or any showing of financial ability to repay").

[36]Compl. ¶ 53; Compl. Ex. 8.

attached to, the complaint explains which of the requested documents is publicly available, which Old Hayes already has in its possession, or even why Old Hayes needs the entirety of the wide ranging document production set out in its September 26, 2005 letter, in addition to the documents it should already have from its own internal investigations. To highlight only two examples of these factual ambiguities, the parties appear to dispute even whether Old Hayes can be sure that the plaintiffs have actually paid their portion of the settlement for which they seek indemnification,[37] or whether the plaintiffs' refusal to produce the voluminous information requested might have been justified in view of Old Hayes's alleged refusal to consider any indemnification. To infer, on that undeveloped basis, that the plaintiffs in this case have violated their duties of good faith and fair dealing as a matter of law would be to stray far beyond the boundaries of a motion to dismiss and into the realm of speculation. To the extent such a claim exists, it will have to await further factual development.

D. The SEC Investigation And Ripeness

The defendants claim the court should stay the plaintiffs' indemnification action because the determination of whether the plaintiffs acted in "good faith" and in the "best interests" of Old Hayes, as required by Sections 145(a) and (d) of the Delaware General Corporation Law, cannot responsibly be made until the SEC concludes its investigation of the underlying accounting irregularities and financial restatements that gave rise to the class action. Although no Wells Notices have been issued against the plaintiffs, and no litigation is ongoing against the plaintiffs, Old Hayes claims that it must wait to indemnify until the statute of limitations for action by the SEC against the plaintiffs has run in 2007, or otherwise risk violating its statutory and fiduciary duties.

The defendants' reading of the indemnification agreements and bylaws runs contrary to the plain language of the indemnification agreements, as well as to well established Delaware law. As to the former point, the bylaws are quite clear in promising indemnification for any action, "whether civil, criminal, administrative, or investigative." This standard indemnification language, by enumerating the various kinds of

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[37]Defs.' Opening Br. 25 ("Plaintiffs, however, have refused to provide Old Hayes with any documentation whatsoever regarding the bases of the settlement payment for which they seek indemnification. Not even so much as a canceled check has been offered to show that any of Plaintiffs (as opposed to some other person or persons) 'actually and reasonably incurred' the settlement amount."); Defs.' Reply Br. 20 ("Plaintiffs have also declined, despite Defendants' prompting, to explain their continued refusal to provide any evidence of even so straightforward a matter as the alleged fact that they themselves paid the $7.2 million settlement amount . . . .").