PIKE v. COMMODORE MOTEL CORP.

No. 940

Court of Chancery of the State of Delaware, Sussex

May 10, 1985

Plaintiff sought an accounting of his interest in a motel constructed by the individual defendants and titled in the name of the corporate defendant. Plaintiff claimed that the interest arose as the result of a joint venture agreement, and that an accounting was necessary due to sale of the motel and dissolution of the corporation. Defendants acknowledged an initial agreement, but contended that no joint venture ever came into being. Alternatively, defendants alleged that plaintiff had forfeited any entitlement to share in the venture's assets through his misconduct and failure to deal fairly with the venture.

The court found that the defendants agreed to form a joint venture in order to obtain bank financing. Plaintiff's refusal to pay the $25,000 capital contribution and provide the $25,000 in furnishings was not an abandonment of the venture, nor was it in bad faith, since it was withheld in a dispute over a larger amount owed to plaintiff by defendants.

The court of chancery, per Vice-Chancellor Walsh, held that a joint venture was created, that plaintiff did not abandon the joint venture and that plaintiff was entitled to share in the proceeds of the corporate dissolution, subject to an offset of $25,000 for his capital contribution. If the parties are unable to agree on the value of plaintiff's interest, another hearing will be held.

1. Joint Adventures ⟹ 1.2

A joint venture is an enterprise undertaken by several persons jointly to engage in a common plan or project for their mutual benefit with a sharing of capital, skill, and effort.

2. Joint Adventures ⟹ 1.8

The parties to a joint venture may allocate proportionate control if that is their intention.

3. Joint Adventures ⟹ 1.4

In an action for an accounting of an interest in a joint venture

agreement, it is the agreement of the parties, express or implied from their conduct, which controls the formation and terms of the relationship, not operation of law.

4. Joint Adventures ⟹ 1.8

When determining whether a joint venture exists, the fact that a party receives a minority position is not inconsistent with the concept of a joint venture if it is the intention of the parties that management not be equally shared.

5. Corporations ⟹ 629

Generally, unless stock has been properly issued for a valid consideration, a subscriber is not entitled to share in the dissolution of the corporation.

6. Corporations ⟹ 99(1)

Stock improperly issued is not void but voidable at the option of the issuing corporation.

7. Corporations ⟹ 90(2)

The court of chancery may recognize the equitable claim of a shareholder who has not paid a proper consideration but has conferred a substantial benefit upon the corporation.

8. Corporations ⟹ 90(3), 629

A party to a joint venture cannot be denied his share simply because the indicia of title in the form of corporate shares were not issued before the time the corporation was dissolved.

9. Corporations ⟹ 187

Joint Adventures ⟹ 4(1)

Both the controlling shareholders of a closely held corporation and the holders of majority control in a joint venture owe a fiduciary duty to demonstrate the fundamental fairness of their conduct of the enterprise.

10. Corporations ⟹ 155(2)

A minority shareholder is not entitled to share in corporate profits unless declared in the form of dividends. DEL. CODE ANN. tit. 8, § 170 (1953).

11. Corporations ⟹ 629

A minority shareholder is entitled to share in the distribution of net assets in the event of dissolution, and a trustee or receiver will be appointed, if necessary. DEL. CODE ANN. tit. 8, §§ 279, 281 (1953).

Roderick R. McKelvie, Esquire, of Ashby, McKelvie & Geddes, Wilmington, Delaware, for plaintiff.

Myron T. Steele, Esquire, and William L. Witham, Jr., Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Dover, Delaware, for defendant.

Walsh, *Vice-Chancellor*

The plaintiff, Vernon E. Pike ("Pike") seeks an accounting of his claimed interest in a motel in Rehoboth Beach constructed by the defendants, Walter Brett and Ellen Brett ("the Bretts") and titled in the name of the corporation defendant, The Commodore Motel Corp. ("the corporation"). Pike contends that he is entitled to a 19% ownership interest in the corporation as the result of a joint venture agreement. The Bretts, while acknowledging an initial agreement to grant Pike an equity interest in the venture, contend that Pike failed to provide the required consideration for the transfer of an equity share and, indeed, obstructed the motel project. This is the decision after trial.

To a point, the chronology of events preceding the construction of the motel is not disputed. In September of 1977, the Bretts, the owners of a small motel in Rehoboth, secured an option on a larger parcel of land located on Rehoboth Avenue, owned by members of the Thoroughgood family. Under the option agreement the Thoroughgoods agreed to sell the parcel for $360,000 and to take back a purchase money mortgage for $300,000 which would be subordinated to a construction mortgage if the construction were bonded for the benefit of the Thoroughgoods. The entire transaction was made contingent on the ability of the Bretts to obtain construction financing for the proposed motel. Eventually, the Bretts entered into an agreement with Pike, a general contractor, to build the motel for $871,000, with an additional $125,000 for furniture and furnishings for a total contract price of $996,000.

For several months the Bretts attempted to secure construction financing from a number of area financial institutions, without success. In the course of their efforts a mortgage broker offered to assist

them in securing financing in exchange for one percent of the loan. They rejected this approach. The option under the Thoroughgood agreement was extended until January 28, 1978, to afford the Bretts additional time to secure financing. At some point in their efforts, the Bretts were advised by a loan officer at the Farmers Bank ("the bank"), James Papas, that their only prospect for success was to secure an equity partner for their venture. Papas suggested they explore that arrangement with their contractor, Pike, who was known to Papas as a person of substantial personal and business assets.

Following Papas' suggestion Walter Brett approached Pike with a proposal that Pike acquire a 40% equity interest in the motel project in exchange for a capital contribution of $25,000 and an agreement to assist the Bretts in securing financing. Pike accepted these terms. In addition, the parties agreed to advise Farmers Bank that Pike was also contributing the $125,000 furnishing allowance as part of his equity share. Based on the foregoing agreement, Papas recommended to his bank that it grant a construction loan for the motel in the amount of $1,050,000. The bank's loan committee endorsed Papas' recommendation subject to the following conditions: (1) Pike and his wife must personally guarantee the loan, (2) the construction must be bonded and (3) the bank secure a Small Business Administration ("SBA") guarantee of up to $500,000 of the loan. These terms were acceptable to the Bretts but Pike refused to give a personal guarantee on the loan because of his minority interest in the project. Although the bank later agreed to delete the requirement of a personal guarantee by Pike it was learned that a condition of the SBA loan was that all equity participants with a 20% interest, or more, were required to guarantee the SBA loan. It was then agreed that Pike would avoid this requirement by taking a 19% interest in lieu of the 40% previously determined.

A further problem loomed after the loan was received. Pike learned that he could not secure a construction bond on a project in which he was both the builder and an equity owner. After the Thoroughgoods refused to waive the bonding requirement, even though Pike agreed to guarantee the purchase money mortgage, the parties agreed that Pike would not take his equity position until after the construction had been completed. It was also agreed that Pike would not be required to pay the $25,000 consideration until he was in a position to acquire the stock. To that end, a certificate for 190 shares of the corporation's 1,000 authorized shares was placed in the name of Vernon Pike but the Bretts instructed their attorney not to issue the Pike shares until a later date. Settlement on the

construction loan occurred in September, 1978, and title to the land was acquired shortly thereafter. Although the Bretts desired to take title in their individual names, Pike insisted that the property be titled in the name of the corporation.

Pike commenced construction of the motel in October, 1978, and, initially, the parties' relationship was amicable. Pike suggested certain changes in construction including relocation of the pool and strengthening the foundation to permit the later adding of an additional floor. The respective attorneys for Pike and the Bretts exchanged correspondence in December, 1978, in an effort to define the manner in which Pike would exercise his 19% interest in the venture. Although the Bretts acknowledged the extent of Pike's minority interest they refused to commit themselves to terms for sharing control with Pike. Also during the early construction period Pike, acting on the advice of his accountant and to avoid personal tax consequences secured the agreement of the Bretts, and the bank, that the $125,000 furnishing contribution would be made by his construction company and corporate *alter ego,* Vepco, and not from him personally.

The relationship between the parties became strained early in 1979 because of construction delay and what the Bretts perceived as poor workmanship. The motel did not open as scheduled; Vepco was not paid for additional work; the Bretts voided the original certificate for Pike's shares and issued new certificates to themselves for all the corporate shares. In November, Vepco filed a mechanics lien action in the Superior Court and the Bretts filed a counterclaim for delay and breach of contract. The Bretts also notified Pike's bonding company of the claimed default and joined it as a third-party defendant in the mechanics lien action. That action was eventually resolved in April, 1982, when the Bretts paid Vepco $51,250 and dismissed the action against Pike's bonding company.

The project spawned other litigation in the form of an action by Blume, the mortgage broker, who claimed that he was responsible for securing the Farmers Bank construction loan and was entitled to a 1% fee. The Bretts successfully defended that action by proving that the Farmers Bank loan was secured not through Blume's efforts but because of Pike's agreement to become an equity partner.

The Bretts operated the motel until October, 1981, when they sold it for $1,717,672. Pike attempted unsuccessfully to block the sale although $100,000 was escrowed from the purchase price to satisfy the mechanics lien action which was then pending. In April, 1982, the Bretts acting under the provisions of 8 *Del. C.* §275, as

the sole stockholders of the corporation unanimously agreed to its dissolution.

Pike contends that he is entitled to a 19% equity interest in the joint venture which led to the construction of the motel. To the extent that his interest has been liquidated through the sale of the motel and the corporate dissolution he claims an accounting of his share. The Bretts counter that no joint venture ever came into being but, if it did, Pike has by his misconduct and failure to deal fairly with the venture entity forfeited any entitlement to share in its assets.

[1-3] A joint venture, or "adventure," is commonly defined as an enterprise undertaken by several persons jointly to engage in a common plan or project for their mutual benefit with a sharing of capital, skill and effort. *J. Leo Johnson, Inc. v. Carmer,* Del. Supr., 156 A.2d 499 (1959); 46 *Am. Jur. 2d Joint Ventures* §1. While equality of control is often an element of a joint venture the concept is a flexible one permitting the parties to allocate proportionate control if that is their intention. *Sheppard v. Carey,* Del. Ch., 254 A.2d 260 (1969). It is the agreement of the parties, expressed or implied from their conduct, which controls the formation and terms of the relationship, not operation of law. *Sheppard, supra;* Pan American T. & I. Corp. v. Commercial Metals Co., Del. Ch., 154 A.2d 151 (1959); *Consolidated Fisheries Co. v. Consolidated Sol. Co.,* Del. Supr., 112 A.2d 30 (1955), *modified,* 113 A.2d 576 (1955).

At the outset it is necessary to address the Bretts' contention that, at most, Pike received only the entitlement to become a minority shareholder of the corporation since the parties never intended that their relationship would lead to a joint venture. The evidence simply fails to support this assertion. The Bretts concede that prior to the participation of Pike as an equity partner they had been completely unsuccessful in their financing efforts. Without construction financing the underlying land purchase could not be concluded. Pike's equity participation was thus indispensable to the motel project and the 60%-40% initial sharing of ownership reflected the parties' view of Pike's share in the venture. The later reduction of Pike's interest to 19% was dictated not by the desire of the parties but by the SBA requirement of personal guarantee by certain equity participants. The actual funds to be committed to the project by Pike, or the extent of his day-to-day control of the motel once contemplated, were of little significance to the Bretts during the period of negotiation with the bank. The immediate goal of the parties was to persuade the bank to grant construction financing in the amount requested and the *sine qua non,* in the bank's view, to the granting of the loan

was Pike's role as an equity partner in the venture, even without his personal guarantee of the loan. The importance of that role to the Bretts is evident in their use of Pike's relationship to defeat Blume's claim. Once the loan had been secured, the primary purpose for Pike's presence as a equity participant was satisfied although he continued to exercise a degree of control through his construction modifications which served to enhance the long term value of the venture.

Pike's role as a contractor-owner resulted in a deferral of the receipt of the corporate stock which would have unequivocally identified his equity status. But, again, this action was dictated by the bond condition in the Thoroughgood contract-an agreement entered into by the Bretts before they approached Pike to be an equity participant. It was also Pike's dual status which led to the friction, and ultimately litigation, between the parties. But the merits of that dispute (which apparently favored Pike if the settlement terms are an indication) should not obscure the underlying relationship of joint venture which had been previously reached by the parties. It is true that the precise nature of Pike's participation in the motel project once it became an operating venture was never defined by the parties but, through their attorneys, they recognized that Pike would occupy a minority role upon completion of the project. Pike's minority position is not inconsistent with the concept of a joint venture if it is the intention of the parties that management not be equally shared. *Sheppard v. Carey, supra.*

The Bretts next contend that even if a joint venture existed initially, Pike's subsequent actions reflect an abandonment of the venture and a refusal to perform his joint venture obligations in good faith. The "abandonment" claim is premised upon the admitted fact that Pike did not pay the $25,000 capital contribution required by the initial terms of the joint venture agreement. Pike contends that the $25,000 was not paid, upon the advice of his attorney, because by the time the motel was completed there was an ongoing dispute over construction payments with the Bretts owing his construction company more than $50,000. Moreover, he contends that he could not receive his corporate stock while he continued under a claim of default with his bonding company.

[4] Since I have concluded that Pike has established the existence of a joint venture, the burden of proving its abandonment is upon the Bretts. They have not discharged that burden. There is no claim that Pike expressly abandoned the joint venture and his conduct is not inconsistent with the status of a joint venturer. As previously

noted, Pike's dual status of contractor-owner, a status he assumed with the agreement of the Bretts, prevented him from sharing the indicia of joint ownership. But he clearly attempted to exercise such interest and control as the circumstances of this unusual relationship permitted. There was a blurring of legal entities on both sides of the dispute. Pike identified his interest with those of his construction company, Vepco, while the Bretts considered themselves sole owners of the motel corporation despite the authorized but unissued shares which Pike was entitled to receive when it was legally feasible for him to do so. Pike's refusal to tender the $25,000 at a time when a larger sum was owed him by the Bretts can hardly be viewed as abandonment or action taken in bad faith.

The Bretts' additional defenses of unclean hands and laches are subject to the same deficiency of proof. Pike's refusal to tender the $25,000 until the litigation had been resolved was reasonable under the circumstances and the claim that he defaulted in the agreement to provide $125,000 in motel furnishings is equally unpersuasive. As previously noted, the responsibility for the $125,000 furnishing contribution was shifted from Pike to Vepco with the knowledge of the Bretts and with the consent of the bank. I have some difficulty understanding the laches argument. The parties have been in almost continuous litigation since completion of the motel in 1979 and this action was commenced in December, 1981. It was not until settlement of the mechanics lien action in April, 1982, that Pike could tender the $25,000 payment without the entanglement of his construction claim. It was in that same month that the Bretts dissolved the corporation thus rendering meaningless possession of the stock certificates.

The action of the Bretts in selling the motel prior to the settlement of the mechanics lien action also had the effect of preventing the parties from arriving at a formula for the sharing of profits in accordance with their joint venture agreement. Thus, while this important element of the joint venture agreement was lacking, its absence is attributable to the collateral construction dispute and not because it was outside the contemplation of the parties.

[5-7] Finally, the Bretts argue that Pike is not entitled to an accounting for his 19% interest in the joint venture because he never paid the subscription price for his stock and thus never achieved the status of a shareholder. Unless stock had been properly issued for a valid consideration, the argument runs, a subscriber is not entitled to share in the dissolution of the corporation. As a statement of general corporate law this argument is soundly based. *Grone v. Eco-*

nomic Life Insurance Company, Del. Ch., 80 A. 809 (1911). But stock improperly issued is not void but voidable at the option of the issuing corporation, *Finch v. Warrior Cement Corp.,* Del. Ch., 141 A. 54 (1928), and the Court of Chancery may recognize the equitable claim of a shareholder who has not paid a proper consideration but has conferred a substantial benefit upon the corporation. *Maclary v. Pleasant Hills,* Del. Ch., 109 A.2d 830 (1954). This approach is a practical application of the maxim that "Equity regards that as done which ought to be done."

[8,9] In any event, Pike seeks in this action not so much the issuance of the shares but an accounting for what the shares represent in dissolution. He cannot be denied his 19% share in the joint venture simply because the indicia of title in the form of corporate shares were not issued before the time the corporation was dissolved. Whether viewed as controlling shareholders of a closely held corporation, or as holders of majority control in a joint venture which merely assumed a corporate form, the Bretts owe a fiduciary duty to Pike to demonstrate the fundamental fairness of their conduct of the enterprise. *Weinberger v. UOP, Inc.,* Del. Supr., 457 A.2d 701 (1983).

[10,11] Because the parties have agreed that the Court should first determine whether Pike has established the existence of a joint venture and the extent of his interest, I make no attempt to fix the value of that interest. A further hearing may be required for that purpose. A condition of such accounting, however, will be the requirement that Pike pay his previously tendered $25,000 capital contribution or accept an offset in that amount. *Maclary v. Pleasant Hills, supra.* It should be noted that as a minority shareholder Pike, in the absence of a specific agreement to the contrary, is not entitled to share in corporate profits unless declared in the form of dividends. 8 *Del. C.* §170; *Moskowitz v. Bantrell,* Del. Supr., 190 A.2d 749 (1963). In the event of dissolution, however, his entitlement to share in the distribution of net assets is statutorily secured through the appointment of a trustee or receiver, if necessary. 8 *Del. C.* §§279, 281.

In summary, I conclude that Pike has established the existence of a joint venture with the Bretts and his entitlement to 19% share in the venture. If the parties cannot agree on the value of that interest, the Court will conduct a further hearing.

IT IS SO ORDERED.

STEIN v. ORLOFF

No. 7276

Court of Chancery of the State of Delaware, New Castle

May 30, 1985

In this derivative action, plaintiff shareholder, on behalf of all shareholders of the corporation, brought suit challenging the actions of the directors. Plaintiff claimed that directors' actions constituted breach of fiduciary duties concerning the appointment of directors amounting to the sale of corporate offices. Plaintiff also charged defendants with wastes of corporate assets in connection with the setting of stock option prices, compensation to officers, and sale of two of the corporation's divisions.

The court of chancery, per Vice-Chancellor Hartnett, held that because plaintiff had not alleged sufficient facts to demonstrate demand futility, the complaint must be dismissed for failure to make a pre-suit demand as applies to all allegations except those involving waste of corporate assets since suit contained sufficient allegations to state a claim for the latter action.

1. Corporations ⟹ 206(4)

A motion to dismiss under Rule 23.1 where there has been no pre-suit demand requires that the court of chancery must decide whether the particular facts alleged give rise to a reasonable doubt that the directors were disinterested and independent or that the challenged transaction is protected by the business judgment rule from further judicial scrutiny. DEL. CH. CT. R. 23.1.

2. Corporations ⟹ 206(4)

Where challenged transactions occurred over a period of time so that the composition of the board of directors was not the same at all times material to the challenged actions, the issue of whether a pre-suit demand would have been futile will be determined with reference to the circumstances existing at the time of commencement of the action.

3. Corporations ⟹ 206(4)

The allegation of control, designation, and participation and approval of the transaction without allegations of facts to support the allegations are insufficient to excuse the failure to make a pre-

suit demand pursuant to Delaware Chancery Court Rule 23.1.

4. Corporations ⟹ 320(8)

In shareholder's derivative action, mere allegations of business relationships by corporate directors and major stockholder that do not state facts with particularity are not sufficient to show that there is a reasonable doubt that the directors were independent or disinterested.

5. Corporations ⟹ 310(2)

Unless facts are alleged from which it could be shown that board members acted in a grossly negligent manner in approving a challenged transaction, such board members will not be denied the protection of the business judgment rule.

6. Corporations ⟹ 312(7)

Where waste of corporate assets is alleged, the test for finding waste of corporate assets is whether the consideration received by the corporation was so inadequate that no person of ordinary sound business judgment would deem it worth that which the corporation paid.

7. Corporations ⟹ 320(7)

In a stockholder's derivative action, a complaint alleging preexisting options on which the option price was reduced without any consideration being received for the reduction is a sufficient allegation of facts to state a claim for waste.

Irving Morris, Esquire, and Joseph A. Rosenthal, Esquire, of Morris and Rosenthal, Wilmington, Delaware; and Bruce E. Gerstein, Esquire, and Scott W. Fisher, Esquire, of Garwin, Bronzaft & Gerstein, New York, New York, for plaintiff.

Charles F. Richards, Jr., Esquire, and Samuel Nolen, Esquire, of Richards, Layton & Finger, Wilmington, Delaware, for individual defendants and defendant NVF Company.

Victor F. Battaglia, Esquire, and Pamela S. Tikellis, Esquire, of Biggs & Battaglia, Wilmington, Delaware, for defendant Evans Products Company.

HARTNETT, *Vice-Chancellor*

This is a stockholder's derivative action brought by the plaintiff purportedly on behalf of all the shareholders of Evans Products Company challenging a number of transactions involving the corporation. Plaintiff made no demand on the Board of the corporation to take action regarding the alleged wrongful transactions prior to the commencement of this suit. Defendants assert that, because plaintiff has not alleged sufficient specific facts to demonstrate demand futility, the complaint must be dismissed pursuant to Chancery Court Rule 23.1 for failure to make a pre-suit demand. A careful review of the complaint shows that it does not adequately allege that the Board was incapable of independently considering a pre-suit demand if it had been made as to the claims asserted in the Complaint except as to a claim of waste of corporate assets. The complaint does contain sufficient allegations so as to state a claim of waste of corporate assets in connection with the reduction of the purchase price of certain stock options and therefore it will not be dismissed as to those allegations.

I

[1] The Delaware Supreme Court recently stated that

> ". . . in determining demand futility the Court of Chancery in the proper exercise of its discretion 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 judgment."

Aronson v. Lewis, Del. Supr., 473 A.2d 805 (1984), at 814.

In considering a motion to dismiss I am limited to a consideration of the allegations of the complaint and cannot consider other pleadings. *Id.* It is therefore my duty, when faced with a motion to dismiss under Rule 23.1, where there has been no pre-suit demand, to carefully scrutinize the factual allegations of the complaint to determine whether they give rise to a reasonable doubt that the directors were disinterested and independent or that the challenged transaction is protected by the business judgment rule from further judicial scrutiny. There are 83 separate allegations in the complaint.

II

The facts set forth are gleaned from the Amended and Supplemental Complaint ("the Complaint"). Evans Products Company is

a Delaware corporation engaged in the business of manufacturing and distributing building materials, shelter products, automotive heating and ventilating products, and transportation equipment for trucks and railways, as well as the leasing of rail cars. Its common stock is listed and traded on the New York Stock Exchange, and as of May 4, 1983, there were over 12 million shares outstanding.

Victor Posner, the primary subject of the allegations of the Complaint, has large holdings of stock in a number of corporations which in turn have holdings in the same or other corporations. It was not alleged, however, that he owns 50% or more of the common stock of any one of these corporations. He is also Chairman of the Board, President, or Chief Executive Officer, or holds a combination of these offices with a number of these corporations. These corporations include Sharon Steel Corp. ("Sharon"), Summit Systems, Inc. ("Summit"), NVF Company ("NVF"), DWG Corporation ("DWG"), APL Corporation ("APL"), and Southeastern Public Services Company ("Southeastern"). Also involved is Security Management Corp.—described in the Complaint as "a privately held Posner family corporation."

During 1980 and 1981 two of these corporations, Sharon and Summit, purchased shares of Evans Products Company's common stock. On November 12, 1981, these corporations held over 43% of Evans Products' outstanding common shares.

[2] The plaintiff challenges several transactions which were undertaken by the Board of Directors of Evans Products Company. The composition of the Board was not the same at all the times material to the challenged actions, but the issue of whether a presuit demand would have been futile will be determined with reference to the circumstances existing at the time of commencement of the action. *Aronson v. Lewis, supra.*

III

On February 17, 1982, six of the director-defendants were granted five-year employment contracts and another director-defendant's existing employment contract was amended. These contracts guaranteed payment of the then present value of all payments due under the contracts unless there was a termination for cause or the employee chose to terminate the contract in accordance with its provisions. Termination at the employee's option was to be permitted in the event of (1) a merger, consolidation, or sale of assets of the corporation, (2) an acquisition of more than 50% of the outstanding

shares of the corporation by a single stockholder, or (3) the then current membership of the Board of Directors of the corporation was reduced to less than 60% of the total Board. If an employee so chose to terminate for one of the stated reasons then he would be entitled to receive 12 months salary. Amendments extending the duration of the contracts or increasing the yearly minimum salary were subsequently made to two of these agreements.

On February 19, 1982, two days after these employment agreements were made, Evans Products Company entered into an agreement in principle to merge with Sharon Steel Corporation. Under the agreement Sharon's parent, NVF, would have held approximately 56% of the stock of the resulting entity. The proposed merger was never consummated, however, because Evans Products Company was advised in April of 1983 that its creditors would not approve the merger.

The Complaint further alleges that the employment agreements were designed so that the proposed, and thus foreseeable, merger would automatically trigger the benefits.

It is also alleged that after the merger attempt failed Mr. Orloff, the Chairman of the Board of Evans Products Company, and Mr. Posner entered into a plan whereby each would designate half the members of the Board of Evans Products Company.

At the Evans Products Company Board meeting on April 20, 1983, a number of changes took place. The Board of Directors expanded its number from 14 to 16. Three members of the Board resigned and two days later a fourth resigned, while four new members were elected (including Mr. Posner and his son, Stephen Posner). Mr. Orloff then resigned as Chairman of the Board in favor of Mr. Posner, and Stephen Posner was appointed Vice Chairman. Mr. Orloff, Mr. Posner and Stephen Posner were then appointed as the three members of Evans Products Company's Executive Committee.

A Board composed of 16 directors was elected at a shareholders' meeting on June 8, 1983. The Complaint alleges that Mr. Posner designated eight of the members and that Mr. Orloff designated the other eight members.

The Complaint alleges that as an inducement to Mr. Orloff to allow the changes on Evans Products Company's Board, he was elected to the Boards of both Sharon and NVF and as President, Chief Executive and member of the Board of DWG. He was given a five-year employment contract with DWG for $390,000 per year. This contract is alleged to be a sham and allegedly intended as "payment for the sale of offices and directorships which are assets

belonging exclusively to Evans Products Company." The DWG contract is alleged to be in violation of Mr. Orloff's contract with Evans Products Company which requires his full-time services in exchange for a minimum salary of almost $600,000.

In January of 1984 a number of changes occurred in Evans Products Company's senior management. Mr. Posner was named Chief Executive Officer. Mr. Colvin, a Senior Vice President of Sharon and NVF and a member of the Posner family, replaced Mr. Robinson on the Board of Directors and was made a Senior Vice President. A number of other people who also hold positions with other corporations in which Mr. Posner holds substantial interests were appointed to management positions with Evans Products Company. Among these is Tracy Posner—Mr. Posner's then 21-year-old daughter—a recent college graduate who was appointed Vice President, Assistant Secretary, and Assistant Treasurer.

In response to this management shift, several high-ranking employees of Evans Products Company resigned—including Mr. Bragdon who resigned from the Board of Directors.

As will be seen, these allegations do not adequately state facts with sufficient particularity to excuse the failure to have made a pre-suit demand.

IV

[3] It is now well settled that mere conclusory allegations of domination and control, as well as allegations that a benefitted shareholder designated the directors and that they owe their positions to him, are insufficient to excuse a pre-suit demand under Chancery Rule 23.1. See *Aronson, supra.* In order to excuse demand there must be allegations of fact which raise a reasonable doubt as to the actual independence of the directors and these facts must demonstrate that the directors are beholden to the controlling person through personal and other relationships. *Id.* Mere allegations of participation in the approval of the transaction are similarly insufficient. *Id.*

> "Directorial interest exists whenever divided loyalties are present, or a director either has received or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders. The question of independence flows from an analysis of the factual allegations pertaining to the influences upon the directors' performance of their duties generally, and more specifically in respect to the challenged transaction."

Pogostin v. Rice, Del. Supr., 480 A.2d 619 (1984), at 624 (citations omitted).

The allegation of control, designation, and participation and approval of the transaction without allegations of facts to support the allegations are therefore insufficient to excuse the failure to make a pre-suit demand pursuant to Chancery Rule 23.1.

[4] The Complaint also contains allegations of extensive business relationships between the various directors and Mr. Posner. The existence of these relationships, absent more, is also insufficient to excuse the failure to make a pre-suit demand. No facts are alleged which suggest that the directors would not have retained their other positions unless they acted in accordance with Mr. Posner's wishes. See *Kaufman v. Belmont,* Del. Ch., 479 A.2d 282, 288 (1984).

The allegations of lack of independence of the directors, therefore, do not state facts with particularity which would lead me to conclude that there is a reasonable doubt that the directors were independent or disinterested. The directors therefore could have impartially entertained a pre-suit demand.

V

[5] It is also clear that no facts are alleged in the Complaint which would give rise to a reasonable doubt that the Board members had acted in such a grossly negligent manner in approving the challenged transactions as to deny themselves the protection of the business judgment rule See *Smith v. van Gorkom,* Del. Supr., 488 A.2d 858 (1985).

The Complaint does contain an allegation that the realignment of the Board in April of 1983 constituted a sale of corporate offices by Mr. Orloff who allegedly received certain positions and compensation with other corporations for his part in the organization. Unfortunately for the plaintiff, however, there is no allegation of facts in the Complaint which, if true, show that any of the members of the Board at the time suit was filed, let alone a majority of them, were beholden to and controlled by Mr. Orloff.

V I

Some of the allegations of wastes of corporate assets are, however, sufficient to raise a reasonable doubt that the challenged transactions were the product of a valid exercise of business judgment.

Evans Products Company's 1979 Stock Option Plan ("1979

Plan") provides for a price determination for the exercise of options by a Stock Option Committee which must be no less than "fair market value of the stock." The fair market value is defined in the 1979 Plan as being the value of the stock as of the date of granting of the option. The 1979 Plan was approved by Evans Products Company's shareholders at the annual meeting in May of 1979. No provision of the 1979 Plan allows the Board of Directors to amend the terms of previously granted options.

In January of 1983 the Board purported to approve an amendment to the 1979 Plan to allow the Stock Option Committee to reduce the option price of previously granted options although the price still must be no less than "fair market value". This amendment was not presented to the shareholders.

The Complaint alleges that the amendment was designed to permit the lowering of the exercise price of the options to the then lower market price and thus to enable holders of the options to benefit from an "inevitable" rise in market price even if that rise still kept the price substantially below the original option price.

At the same time that the amendment to the stock option plan was purportedly made, the Stock Option Committee reduced the exercise price of outstanding options for 225,000 shares of Evans Products Company's stock from $20.125 to $12.625 per share effective three months later in April of 1983. Seven members of the then Board of Directors held options as to more than 3/4 of these shares. Five of these directors were still members of the Board at the time this suit was brought.

It is alleged that the reduction in option price was given without consideration and constituted a waste of corporate assets. It is further alleged that the amendment to the 1979 Plan had to be approved by the shareholders.

[6,7] The test for finding a waste of corporate assets is whether the consideration received by the corporation was so inadequate that no person of ordinary, sound business judgment would deem it worth that which the corporation paid. *Saxe v. Brady,* Del. Ch., 184 A.2d 602 (1962). The Complaint alleges pre-existing options on which the option price was reduced without any consideration being received for the reduction. This is a sufficient allegation of facts to state a claim for waste and therefore to create a reasonable doubt that the transaction was the result of a valid exercise of business judgment. See *Michelson v. Duncan,* Del. Supr., 407 A.2d 211 (1979).

V I I

The compensation granted to Posner family members and others by Evans in 1984 is also alleged by the plaintiff as not being related to their experience in managing Evans Products Company's affairs and as such to be lacking in consideration and to be a gift and a waste of corporate assets.

The allegations as to the compensation granted to the Posner family are, however, not sufficient to state a claim of waste. There is no assertion of fact which creates a reasonable doubt that these people were performing services for Evans so inadequate as to be insufficient consideration for their fees. This is, therefore, an insufficient allegation of waste for demand excusal purposes on the excessive compensation claims.

Waste is not alleged as to the 1982 employment contracts. Even if these contracts with their termination provisions were, however, in contemplation of a foreseen merger, no allegation is made that the employees did not continue in their jobs and perform valuable services for Evans Products Company. The fact that Mr. Orloff accepted employment with other corporations may be a breach of his promise to provide substantially all of his business time to Evans Products Company but it does not convert the contract into a waste of corporate assets.

V I I I

The Complaint also alleges that in March of 1984 Evans Products Company sold two of its divisions. The Shelter Products Group ("Shelter Group") was sold to APL for $45 million, and the Evans Fiber Products Group ("Fiber Group") was sold to DWG for $30 million. These prices are alleged to have been substantially less than the fair market value of each of the divisions and thus a waste of corporate assets.

The Complaint alleges that substantive inquiries were made by other companies wishing to purchase one or the other or both of the divisions. It is alleged that these inquiries were not pursued before the sale of the two divisions to corporations in which Mr. Posner had substantial holdings of stock.

At the time the Complaint was supplemented to allege these new wrongs seven of the members of the Evans Products Company's Board of Directors were also directors or officers of DWG and four were also directors or officers of APL—both corporations allegedly controlled by Mr. Posner.

The Complaint contains allegations that there had been substantive inquiries made by others seeking to purchase the Fiber Group and the Shelter Group divisions. The only offer which is specifically mentioned, however, is an offer from a group organized by Dr. Zenczak who was formerly a director of Evans Products Company and President of the Fiber Group. The offer was allegedly for $34 million for the Fiber Group which was sold to DWG for $30 million. There is no allegation that the terms, other than price, were the same, nor is there an allegation as to the timing of the Zenczak offer. It is reasonably likely that a difference in terms could have accounted for the acceptance of the lower price if the two offers had been considered together. These allegations, therefore, do not sufficiently allege such facts as to create a reasonable doubt that the Board properly exercised its business judgment.

STERLING SOFTWARE, INC. v. INFORMATICS GENERAL CORP.

No. 8009

Court of Chancery of the State of Delaware, New Castle

May 2, 1985

The plaintiff corporation filed this action pursuant to Del. Code Ann. tit. 8, § 220 seeking stocklist materials from the defendant corporation. They later amended their complaint seeking postponement of the defendant's annual meeting. The plaintiff was provided with stocklist materials and trial was held to determine whether the meeting should be postponed. The court of chancery, per Vice-Chancellor Berger, determined that the meeting need not be postponed due to the fact that the plaintiff's ability to conduct a proxy fight had not been seriously prejudiced. The court found that stocklist materials had been provided only two days after the plaintiff had cleared its proxy materials with the SEC and that the plaintiff's materials had been promptly mailed to the shareholders of the defendant corporation.

1. Corporations ⟹ 584

Shareholder meetings may be postponed where stocklists were withheld and the postponement is necessary in order to allow plaintiff sufficient time to communicate with shareholders prior to the meeting.

John H. Small, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware, for plaintiff.

David A. Drexler, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware, for defendant.

BERGER, *Vice-Chancellor*

Plaintiff, Sterling Software, Inc. ("Sterling"), filed this action on April 23, 1985 pursuant to 8 *Del. C.* §220 seeking a stocklist and related materials from defendant, Information General Corporation ("Informatics"). On April 25, 1985, Sterling amended its complaint to seek an order pursuant to 8 *Del. C.* §220(c) postponing the scheduled annual meeting date of May 9, 1985 in order to allow Sterling the opportunity to solicit proxies and otherwise communicate with Informatics' shareholders. On April 29, 1985, Informatics provided Sterling the stocklist materials previously demanded. However, trial was held on April 30, 1985, as originally scheduled, on the remaining issue of whether the annual meeting should be postponed.

There appear to be no Delaware cases where this type of relief has been awarded in a stocklist case. Two federal courts, applying Pennsylvania law, have issued preliminary injunctions postponing shareholder meetings where stocklists were withheld and the postponement was necessary in order to allow plaintiff sufficient time to communicate with shareholders prior to the meeting. *Steinberg v. American Bantam Car Co.,* 76 F. Supp. 426 (W. D. Pa. 1948); *Susquehanna Corporation v. General Refractories Company,* 250 F. Supp. 797 (E. D. Pa. 1966) *aff'd.,* 356 F.2d 985 (3d Cir. 1966). The *Susquehanna* case distinguishes *American Hardware Corp. v. Savage Arms Corp.,* Del. Supr., 136 A.2d 690 (1957), apparently the only Delaware case addressing this issue.

In *American Hardware,* plaintiff asked that a shareholder meeting called to consider a proposed plan for the purchase of certain assets be adjourned until plaintiff could present to the shareholders a wholly unrelated plan. Plaintiff alleged that defendants had delayed in providing it with a stocklist and other information needed to complete

a registration statement relating to plaintiff's proposal. The Court found that, since plaintiff's proposal was unrelated to the subject of the meeting, any such delay would not justify adjournment of the meeting.

Based upon these authorities and general principles of equity, Sterling asks that the annual meeting be postponed for two weeks. Assuming, without deciding, that such relief ancillary to a §220 action may be appropriate in a given case, this is not the case.

As early as January, 1985, Sterling was discussing with Informatics its interest in a business combination. Those discussions did not lead to an agreement but Sterling remained interested in a merger and in mid-March purchased just under 5% of Informatics' outstanding stock. On April 15, 1985, Sterling made a cash merger offer and on April 22, 1985 Sterling raised the price of its offer.

Informatics sent out its Notice of Annual Meeting on March 25, 1985 but Sterling waited until almost three weeks later before making its demand for the stocklist. Given Sterling's interest in negotiating a friendly deal, it is apparent that Sterling waited as long as it felt it could before switching to an adversarial mode by demanding a stocklist in preparation for a proxy fight. Indeed, Sterling's proxy materials were not cleared by the SEC until April 27, 1985, only two days before the stocklist materials were provided. Moreover, on April 27, 1985 pursuant to SEC Rule 14a-7, Informatics mailed Sterling's proxy materials to its shareholders.

Under these circumstances, I am not persuaded that Informatics' failure to provide the stocklist materials until April 29, 1985 seriously prejudiced Sterling's ability to conduct a proxy fight. As a result, I conclude that the Informatics' annual meeting should not be postponed.

IT IS SO ORDERED.